



# From Chaos to Clarity:

How Current  
Cost-Based  
Strategies Are  
Undermining the  
Department of Defense

INFINITE OBSTACLES...

...INFINITE OPPORTUNITIES

Report of the  
Military Research Fellows  
DAU 2000-2001

Lt Col Warren M. Anderson, USAF  
LTC John J. McGuiness, USA  
CDR John S. Spicer, SC, USN

September 2001

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**DEFENSE ACQUISITION UNIVERSITY**

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# TABLE OF CONTENTS

	Page
<b>Preface</b> .....	vii
<b>Executive Summary</b> .....	ix
<b>Acknowledgments</b> .....	xv
<b>Defense Acquisition University Military Research Fellows Program</b> .....	xvii
<b>Introduction</b> .....	I-1
Effectiveness, Efficiency, and Business Strategy .....	I-1
Purpose of the Study .....	I-3
Department of Defense Business Perspective .....	I-4
Budgetary Pressure and the Drive to Reduce Cost .....	I-5
Execution of Public Policy and the Establishment of Strategic Boundaries.....	I-5
Resource Allocation .....	I-7
Strategy Drives Structure .....	I-7
Overview of the Report.....	I-7
Objective of this Study .....	I-8
<b>Chapter 1 – Business and Government in the Twenty-First Century</b> .....	1-1
Introduction .....	1-1
Global Transition and Challenges .....	1-2
End of the Cold War .....	1-3
The Impact of Downsizing on the Defense Industry .....	1-5
The Post-Consolidation Defense Industry .....	1-8
Impact on Equity Markets .....	1-9
Debt Markets .....	1-10
Trends and Opportunities in the New Global Economy .....	1-11
Recurring Technological Revolution .....	1-13
The Revolution Continues .....	1-15
The Information Economy .....	1-15
From Make and Sell to Sense and Respond .....	1-18
Impact on the Organization .....	1-18
Potential for this New Technology for DoD .....	1-20
Summary .....	1-20



<b>Chapter 2 – Key Terms, Concepts, and Definitions .....</b>	<b>2-1</b>
Introduction .....	2-1
Outsourcing — An Outcome of Strategy .....	2-1
What Then Is Strategy? .....	2-6
A Resource-Based View of Corporate Strategy .....	2-9
Tools of the Trade .....	2-14
Five Forces Analysis .....	2-14
Value Chain Analysis .....	2-17
The Value Net .....	2-19
Levers of Control .....	2-19
Game Theory .....	2-24
Summary .....	2-26
 <b>Chapter 3 – Business Approaches to Strategy, Integration, and Outsourcing .....</b>	 <b>3-1</b>
Introduction .....	3-1
Limits to the Size of the Firm .....	3-2
Analysis of Vertical Integration .....	3-7
Creating and Capturing Value .....	3-10
Strategy Drives Structure .....	3-12
Differentiation .....	3-13
Brand Image .....	3-13
Integrating and Outsourcing .....	3-14
Cost Leadership .....	3-14
Market Analysis .....	3-14
Strategic Implications .....	3-15
Other Considerations .....	3-16
Vulnerability of Cost Strategies to Disruption .....	3-16
Strategic Cost Analysis .....	3-17
Focus .....	3-18
Integration and Outsourcing .....	3-18
Differentiation Focus .....	3-19
Cost Focus .....	3-19
Integration and Outsourcing .....	3-20
Stuck in the Middle .....	3-20
Moving Out of the Middle .....	3-20
Drifting into the Middle .....	3-22
Strategy and Outsourcing .....	3-24
Case Study: Successful Outsourcing .....	3-24
Case Study: Unsuccessful Outsourcing .....	3-25
Summary .....	3-27
 <b>Chapter 4 – The Department of Defense’s Business Strategy             and Competitive Sourcing Program .....</b>	 <b>4-1</b>
Introduction .....	4-1
Strategy Development .....	4-2

A Look at Alignment .....	4-3
Historical Background of DoD Sourcing .....	4-12
Defense Reform Initiative .....	4-12
Defense Reform Initiative Directive 20 Report .....	4-15
Federal Activities Inventory Reform Act .....	4-16
OMB Circular A-76 .....	4-18
Strategic Sourcing .....	4-21
Results to Date .....	4-23
Factors that Influence Savings .....	4-24
Study Initiation and the Performance Work Statement .....	4-25
Baseline Cost Estimates .....	4-26
Unrecognized Costs of the Competition .....	4-26
Tracking Costs .....	4-28
Initiating and Completing Studies .....	4-29
Summary .....	4-31
 <b>Chapter 5 – Why Results Have Been Marginal</b> .....	 5-1
Introduction .....	5-1
A Strategic Framework for the Department of Defense .....	5-1
Belief Systems .....	5-2
Vision .....	5-6
Mission .....	5-7
From DoD Beliefs, Vision, and Mission, to DoD Strategy .....	5-8
Implementing Strategy through Levers of Control .....	5-11
Boundary Systems .....	5-11
Diagnostic Control Systems .....	5-13
Interactive Control Systems .....	5-15
Compliance and Execution Incentives .....	5-15
Spans of Accountability and the Profit Motive .....	5-16
Cost Center Accountability .....	5-16
Impetus to Generate Savings .....	5-17
Strategy or Execution Failure? .....	5-18
Transformation Urgency .....	5-18
Summary .....	5-19
 <b>Chapter 6 – DoD Corporate Strategy and Outsourcing</b> .....	 6-1
Introduction .....	6-1
DoD Corporate Strategy .....	6-2
Five Forces Analysis .....	6-2
Suppliers .....	6-2
Buyers and Customers .....	6-4
Potential Entrants to the Market .....	6-4
Substitute Products or Services .....	6-5
Rivalry among Existing Competitors .....	6-5
Formulating a DoD Corporate Strategy .....	6-7

DoD Corporate Strategy Execution and Outsourcing .....	6-10
Aligning DoD to the Differentiation Strategy .....	6-11
Controlling Strategy Implementation through Levers of Control .....	6-13
Belief Systems .....	6-13
Boundary Systems .....	6-14
Diagnostic Control Systems .....	6-15
Interactive Control Systems .....	6-16
Is the New Approach Achievable? .....	6-16
Summary .....	6-18
<b>Chapter 7 – Conclusions and Recommendations .....</b>	<b>7-1</b>
Conclusions .....	7-1
Recommendations .....	7-4
<b>Epilogue .....</b>	<b>Epilogue-1</b>

## APPENDICES

Appendix A Circular A-76 .....	A-1
Appendix B Federal Activities Inventory Reform Act of 1998 .....	B-1
Appendix C Department of Defense Appropriation Accounts .....	C-1
Appendix D Outsourcing Survey .....	D-1
Appendix E Contacts .....	E-1
Appendix F Selected Bibliography .....	F-1
Appendix G Acronyms .....	G-1
Appendix H About the Authors .....	H-1

# PREFACE

For each of us this has been an enlightening year of study and research. Being selected for the Defense Acquisition University (DAU) research fellowship program was both an honor and a wonderful opportunity. DAU sponsored our application and enrolment in the Harvard Business School Program for Management Development (PMD). This ten-week executive education program brings together a diverse group of business leaders from over 30 countries to learn state-of-the-art management techniques and the technologies necessary for success in the global marketplace. The program is designed so that the 160 participants learn as much from the individual experiences and insights of their classmates as they do from Harvard professors and classroom study. It surpassed all of our expectations.

Before departing for Harvard, we were provided a broad topic for study. It was then left to us to refine that topic into a more narrow focus suitable for an eleven-month research effort. The topic provided to us was "Effectiveness of DoD's Implementation of Outsourcing, Privatization, and Commercial Acquisition Practices." The topic was broad indeed. In the weeks before PMD, we considered several narrow areas for concentration. However, while in the program, we were exposed to numerous case studies and related literature on the formulation and execution of business strategies. The more we studied this topic, the more we were intrigued and the more parallels we were able to draw between the corporate world and business functions within the Department. In our minds, we felt that this was a valuable perspective by which to examine the broad topic assigned to us. We also felt the application of business strategy methodologies represented a valuable analytical tool with which DoD could examine some of the problems it now faces.

Throughout this fellowship, we have been mindful of the investment DoD has made in us, the privilege that was ours to attend such a prestigious program, and what we owe in return. In her article, *Leading the Change Adept Organization*, Rosabeth Moss Kanter wonders, "...why companies pay as much as they do to send managers to executive education programs but then fail to require that they teach others what they have learned." Taking this as a charge, we have attempted to do just that. In this report, we rely extensively on materials we were able to review at the Harvard Business School. These include class lectures, case studies, and texts. Resources also include one-on-one discussions with faculty members and the many hours of discourse, dialogue, and debate we engaged in with the other program participants.

In addition to examination of current business literature, we developed and administered a survey to a limited sample of DoD personnel. This was done in order to gauge attitudes and impressions of current outsourcing initiatives. We did this because we could find no indication that anyone

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had attempted to gather such feedback on a Department-wide basis. The results are quite striking and are included in this report.

We are convinced that support activities within DoD, as well as in other government agencies, can learn much from techniques businesses use to develop and implement strategy. We are also convinced that there is a need to rely on interactive feedback as any business strategy is implemented. We hope that we can convey what we think is a compelling case for reassessing DoD business strategies in order to bring them in balance with the basic tenets of the Defense Department's mission.

## EXECUTIVE SUMMARY

Cost-driven outsourcing strategies are undermining the Department of Defense (DoD). This is the inescapable conclusion we have reached in the course of our research. The effort put into Office of Management and Budget (OMB) Circular A-76 (A-76) and related initiatives is great yet the savings are at best marginal. Moreover, there is evidence these initiatives are degrading mission performance.

Why is this so? First, cost-based initiatives do not align with DoD business strategy. The Defense Department has historically followed a generic strategy of differentiation, not cost leadership. The Department of Defense's beliefs, values, and mission are aligned to support this generic strategy. A-76 and related initiatives, with their focus on cost, are not well suited for an organization such as DoD, which competes on quality, not cost.

This misalignment of strategy and outsourcing policy has generated a great deal of concern within DoD. This is especially true of base and installation commanders who must implement A-76 and related measures. Installation commanders, more so than any other group we surveyed, place mission performance and personnel ahead of cost. This is at odds with current outsourcing policies that place cost ahead of performance and personnel.

Second, as measured by savings goals, the A-76 process has not generated anything near the results expected. These goals are set unrealistically high and as a consequence, motivation to meet them is low. Additionally, any incentive to attain cost saving is secondary to impact on mission performance and personnel. These latter two are central to DoD's differentiation strategy and are strongly reflected in the Department's belief system. Furthermore, mission performance and responsibility toward subordinates are the basic tenets of diagnostic control systems at the unit level, where A-76 must be executed. Cost savings, on the other hand, are the driving metric at the headquarters and staff level. This is the part of the hierarchy that creates but does not implement outsourcing strategy in its current form.

More important, A-76 has not generated the business process improvements needed to transform DoD from an old to a new business model. A-76, by its nature, is a mechanism to make the old model as economical as possible. It is not a process designed to engender more effective business structures.

Under A-76, DoD has the same model with the same vulnerabilities both before and after outsourcing initiatives. Further, while the model may be slightly less expensive, it is not more

effective. In fact, our survey data indicate that mission performance may be suffering as a result of pursuing A-76 and related measures developed by the individual Services.

As long as the outsourcing strategy is cost driven, it will be at odds with DoD's generic business strategy. One of two things can happen to rectify this conflict. Either DoD can modify outsourcing policies, or it can take measures to adopt a new strategy of cost leadership. We recommend the former.

For this and other reasons, we recommend that DoD suspend cost-based outsourcing initiatives. By emphasizing cost, DoD risks losing sight of its primary mission: to fight and win our nation's wars. Given this mission, cost will always be a secondary consideration, not a primary focus. By vastly expanding the number of positions studied under A-76 in order to achieve an unattainable savings target, the Department loses perspective and risks a great deal.

Instead of focusing on core warfighting areas that properly lie within DoD's strategic domain, the Department is instead focused on activities that do not benefit operational forces. Pursuit of cost-based outsourcing is diluting the ability of leadership to concentrate attention on mission effectiveness. This, in turn, impacts mission performance. Resources — especially leadership resources — directed to an ever-expanding number of cost studies are resources that are not directed to the support of operational forces and the development of warfighting skills.

Complicating matters are the current limitations of DoD's accounting systems and the way in which accounts are fragmented and compartmentalized. Savings at one activity or in one account do not necessarily garner savings throughout DoD. Expanding cost analysis beyond the individual activity may in fact show an overall cost increase to the Department.

There is also an impact on organizational learning and growth. What is the consequence of cost-based outsourcing on a culture that has traditionally emphasized product and service quality? For personnel performing functions that bring DoD a competitive advantage, what message is sent when they are told that quality of performance is secondary to cost? Given the vitality of the private economy, how does DoD attract and retain quality personnel in an environment where cost is apparently valued above talent and ability? "Better, faster, cheaper" is often used as a mantra for streamlining initiatives. Unfortunately, under cost-based outsourcing, the mantra becomes "cheaper, cheaper, cheaper."

### **Our Report**

It is often stated that DoD can derive many lessons from business practices in the private sector. Such statements are an acknowledgment of the fact that, while DoD is involved in operations that have no business parallel, there are large segments of the Department involved in day-to-day business-like functions. Some estimate that this business segment represents 70 percent of the vast personnel and material resources that compose DoD.

Typically, this push to adopt business practices has focused on areas such as accounting, information technology management, and acquisition processes. However, very little emphasis has been given

to applying business practices in the areas of business strategy and strategy development. Our report was written to address this shortfall.

This report analyzes DoD business activities using a strategic framework. We use this framework as a means to address issues DoD is facing with regard to current outsourcing policies, and as a means to outline strategic alternatives that may prove more effective to the Department than the cost-focused measures now being pursued.

The Department can, in fact, derive many lessons from business. In addition to imitating best business practices in such disciplines as accounting and operations, it would be helpful to study DoD business operations using corporate strategy as an analytical framework. This framework is a useful reference for discussing some of the issues above as well as DoD's outsourcing initiatives. Instead of a cost-centric approach that yields only marginal savings, a more fundamental solution is mandated.

Our hypothesis is that ongoing outsourcing initiatives will not result in the necessary performance improvements and changes required to transform DoD to meet the challenges of the 21st century because these efforts are focused on doing things right versus doing the right thing.

Further, Department personnel see cost-based outsourcing as a budgetary manpower drill to be performed with little regard to mission effectiveness. An examination of these programs in practice tends to validate this position. No cost is assessed to the disruption caused by A-76 studies or to the resources that must be applied to execute them. Nor are there any diagnostic measures applied in order to gauge customer satisfaction or organizational effectiveness before, during, or after the studies. When asked to respond to the statement, "Outsourcing has improved my mission performance," 59 of the 75 installation commanders who responded (79 percent) said "no." Unfortunately, cost-based outsourcing relies only on efficiency measures. There are no effectiveness measures applied to the process. The sole driving metric is cost to perform the function.

In our report, we will test this hypothesis by answering the following questions:

- Does a transformation urgency exist?
- Do DoD outsourcing initiatives align with DoD business strategy?
- Has the A-76 process generated the results expected?
- Has Strategic Sourcing generated the results expected?
- Have shortfalls resulted from execution problems or are they strategy-related?
- What are the benefits of a new corporate strategy approach?
- Can such an approach be implemented?



The Department needs to look upon itself not through the overused core competency magnifying glass, but from a new, *resource-based view*. Under this examination, DoD derives its competitive advantage not from a set of core competencies, but rather from a collection of unique resources. The choice of strategy is constrained by the current available resources and the speed at which new resources can be acquired. Formulating a strategy that integrates sound processes and smart business decisions will enable DoD to succeed in transforming and driving the right outsourcing solutions.

We provide an analytical framework for examining DoD from a resource-based corporate perspective and develop an approach to outsourcing consistent with this corporate strategy. The goal of this report is twofold. First, we seek to use this framework to analyze DoD business activities in terms of seeking a competitive advantage. As we will show, this framework provides a unique perspective on how to make DoD more effective and, in so doing, will create the desired efficiencies. Second, because of the size and nature of the organization, processes must be developed that will drive the desired outcomes. No amount of restructuring will reduce DoD to the point where change can be dictated from the top. Instead, realignment can best be achieved through the decentralization of certain decision rights. We carefully explore mechanisms to effect a corporate business strategy using measurement and control systems.

### **Current Department of Defense Business Perspective**

In the course of our research, we have noted that DoD focuses almost exclusively on efficiency when conducting business operations. Almost no emphasis is given to devising effective business strategies or examining efficiencies in terms of a value proposition. Giving precedence to efficiency is largely a reaction to the following:

- unrelenting budgetary pressures;
- execution of public policy; and
- resource allocation processes.

This drive to the “bottom line,” however, assumes that DoD already has an effective strategy and merely needs to fine-tune the operation. This is a poor assumption on three counts. First, without conducting a strategic business analysis, DoD cannot be certain it has an effective strategy. Second, DoD should seek best value and not lowest cost. In other words, DoD should garner the most performance for every dollar spent rather than spending the least amount of dollars. Finally, in complex integrated systems, aggregate and not isolated efficiencies must be the focus. In ignoring these, there is an inherent risk that tactical pursuit of cost reductions at the business unit level will drive adverse strategic outcomes.

In the post-Cold War era, defense planners have been subjected to a great deal of budgetary and political pressure to find areas of potential savings in DoD. This focus on savings stems from the notion that streamlining the Department will free up dollars to reinvest into weapon system upgrades and other modernization initiatives. This defines the operating vision. The Department will use

the savings within existing accounts rather than increased budgetary authority to fund various procurement programs. Anticipating these savings, a budgetary shortfall or wedge was incorporated into procurement and operating accounts. This wedge assumed projected savings would be realized in full and then applied to correct for these shortfalls.

This focus on trimming accounts and infrastructure is a tactical and not a strategic move. The focus is on efficiency. Squeezing accounts never addresses the question of strategy — are we doing the right things in the first place?

### **The Need for Strategy and Strategic Boundaries**

The basic tenet behind A-76 is that the Government should not compete with its citizens. Government, therefore, should rely on commercial sources and perform in-house only functions that are inherently governmental in nature. If this policy dates back to 1955, how then did DoD get to the point where it finds itself today with over 150,000 full-time positions that are commercial in nature and are subject to A-76 studies? The inescapable answer is that this policy has been largely ignored.

The Department must firmly establish strategic boundaries around a well-defined strategic domain. This would preclude many of the costly and difficult to reverse integration decisions that have led the Department to the point where resources applied to infrastructure vastly overshadow resources directed to core mission performance.

However, even if DoD had relied on a simple check of the Yellow Pages to see if the activity was available commercially before integrating activities over the past 45 years, the Department would likely still find itself over-integrated. It does not take a great deal of rationalization to justify any activity as being inherently governmental if the qualifying characteristic is that the function is, "so intimately related to the public interest as to mandate performance by Government employees." We hold that the concept of "inherently governmental" should be abandoned when addressing DoD business strategy. Instead, the integration decision should revolve around whether or not integrating the activity provides the Department with a competitive advantage (or conversely, whether integrating the activity will generate a strategic disadvantage). More to the point, if an organization can do a few things well or many things poorly, what are the few things DoD should do to be effective in the performance of its mission?

Such an approach will yield a much different answer than cost-based restructuring. Our report goes beyond the mere slogan that DoD should operate more like a business. We offer a new perspective to demonstrate what operating like a business actually means. It means much more than business efficiency. It entails a focus on the productive use of resources, processes, and culture to gain a competitive advantage. Operating like a business begins with an effective strategy. We submit that a primary focus on effectiveness entails a critical shift in perspective that is much needed within DoD. We believe this discussion is worthwhile and provides a framework for understanding some of the vexing issues DoD currently faces and better strategies for dealing with them.

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# ACKNOWLEDGMENTS

As with any publication, this book represents far more than the work of the individuals cited on the cover. We owe debts of gratitude to many people, a few of whom we'd like to name here.

First of all, we would like to recognize our instructors and colleagues at the Harvard Business School. Professors Steven Bradley, Michael Beer, David Bell, Cynthia Montgomery, Richard Nolan, Thomas Piper, Louis Wells, and Michael Yoshino provided us a well structured and masterfully presented set of case studies and related materials that focused and refined our understanding of the business community. We are also grateful to the other 157 participants in the Program for Management Development for their insights, expertise, discussion, and understanding.

We would like to thank the faculty and staff at the Defense Acquisition University for their professionalism and support during this research effort. Particular thanks go to Alberta Ladymon, Maryellen Tipper, and Greg Caruth. Our every need was met so that we could concentrate on researching and assembling this report.

Additionally, we are grateful to the Department of Defense and to our individual Services for the opportunity to perform this research and for the educational opportunities afforded to each of us throughout our careers. While at Harvard, many people from the United States and countries around the world were much impressed that the military would invest so highly in education. We hope that we acted as good ambassadors for the U.S. military and that we can provide our country a sound return on the resources it has invested in us.

Finally, we would like to thank our families for giving us the time to go away for a ten-week program at Harvard. Separations are a fact of life in the military but, as we have learned, something that should never be taken for granted. We thank our families for their support, their encouragement, proofreading, criticism, but most of all for the pride they show in us.

Warren Anderson

John McGuiness

John Spicer



# **DEFENSE ACQUISITION UNIVERSITY MILITARY RESEARCH FELLOWS PROGRAM**

The Military Research Fellowship Program provides professional military education to selected Fellows and develops new and innovative concepts for systems acquisition management. It was chartered by the Under Secretary of Defense (Acquisition) in 1987 to enhance the capabilities of the then Defense Systems Management College (DSMC), and today the Defense Acquisition University (DAU). This joint fellowship program is a unique opportunity for these selected Fellows to supplement DAU research goals and to impact the defense acquisition process. The program begins in August each year and continues through June of the following year. Part of the program includes an opportunity for education at the Harvard University School of Business. If accepted, selected Fellows attend the ten-week Program for Management Development at Harvard. The remainder of the program is held at DAU.

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# INTRODUCTION

*"The Americans will always do the right thing...  
after they've exhausted all the alternatives."*

— Winston Churchill Sr.

## Effectiveness, Efficiency, and Business Strategy

The mission of the Department of Defense (DoD) is to support and defend the Constitution of the United States; to provide for the common defense of the nation, its citizens, and its allies; and to protect and advance U.S. interests around the world.<sup>1</sup> To support this mission, DoD conducts operations involving over \$1 trillion in assets, budget authority of about \$310 billion annually, and about 3 million military and civilian employees.<sup>2</sup> By any standard, this represents the employment of assets on a

vast scale. Using Fortune 500 companies as a benchmark, one can see that the magnitude of this enterprise easily eclipses the giants of global commerce. Table I-1 provides a quick comparison.

While DoD is involved in operations that have no business parallel, there are large segments of the department involved in business-like functions. For this reason, there have been many calls for DoD to operate in a more business-like manner.<sup>3</sup> Calls for sound business practices within DoD have invariably focused on the need for increased accountability of

Fortune 500 Rank	Company	Revenue (\$M)	Operating Expenses (\$M)	Assets (\$M)	Employees
	DoD		\$310,000	\$1,000,000	3,000,000
1	Exxon Mobil	\$210,392	\$192,672	\$ 149,000	106,000
2	Wal-Mart	\$193,295	\$187,000	\$ 77,895	1,140,000
3	General Motors	\$184,632	\$180,180	\$ 303,100	106,000
4	Ford Motor	\$180,598	\$177,310	\$ 284,421	364,550
5	General Electric	\$129,853	\$117,118	\$ 437,006	340,000

Source: Retrieved from World Wide Web 26 April 2001: [http://www.fortune.com/indexw.jhtml?\\_DARGS=%ZFragments%2Flist2Ffrg\\_list\\_rank\\_f500.jhtml](http://www.fortune.com/indexw.jhtml?_DARGS=%ZFragments%2Flist2Ffrg_list_rank_f500.jhtml).

**Table I-1. Comparison of Fortune 500 Companies and the Department of Defense**



assets and reduced operating costs. While the companies listed in Table I-1 — like all successful companies — are concerned with assets and expenses, they are more concerned with developing a business strategy that will provide them with a competitive advantage, profitable earnings, and a high return on shareholders' equity.

To this end, successful companies begin with a basic business strategy that will provide them with a competitive edge. To do this, companies determine where they want to position their business and what approach they will take to gain market share. This analysis is not done in isolation. Firms not only look at their target market but also take into account the environment in which they operate. Successful firms examine competitors within their industry, the threat of potential entrants, their supplier base, the threat of possible substitutes, and, to an increasing degree, the impact of governmental oversight, regulation, and public scrutiny.<sup>4</sup> This analysis is critical to crafting an effective business strategy. Furthermore, it is not a one-time event. Companies must continuously adapt to changes in the business environment by modifying their strategies. Without this business discipline, companies cannot become successful or sustain their success in a competitive environment.

In their book *Cost and Effect*, Robert Kaplan and Robin Cooper make the distinction between doing things right and doing the right things.<sup>5</sup> This subtle twist of a phrase brings about a critical shift in perspective. An effective business strategy begins with doing the right things. Firms must decide not only what products or services they will produce but also how to craft an operating structure, what activities they will integrate into these operations, and what activities they will not. Firms must decide what processes they will employ, devise effective marketing strategies, map out

distribution channels, and determine what approach they will use to differentiate themselves from their competitors. They must focus on those key resources that build upon the business strategy to create value. All this must be done in the context of a structured industry analysis that takes into account the elements described in the previous paragraph. Doing the right things is about effectiveness and effective strategies.

Conversely, doing things right is about efficiencies and business tactics that will yield efficiencies. When discussing efficiencies, the underlying premise is that an organization is already aligned to be effective. If an entity is not effective, focusing on efficiencies becomes a wasted exercise. Furthermore, in our view, efficiency is not a cost proposition. It is inherently a value proposition. To focus on cost without taking the output and trade-offs into consideration is a recipe for probable disappointment or potential disaster.

By way of example, Henry Ford had an extremely efficient business operation producing the Model T. His product policy was to produce that one car and to keep cutting the cost. Ford was able to do this through standardization of his product and a relentless pursuit of manufacturing efficiencies. The Model T had no options. The only color offered in the U.S. was black and one car looked exactly like another. To reduce production costs, Ford built the vast River Rouge Plant and integrated operations. River Rouge was a model of efficiency. Ford controlled a vast vertically integrated structure that included foundries and machine shops in addition to the assembly line. Through a centralized structure, Ford controlled all essential resources used to produce a Model T, right down to the black paint. Ford's drive to be efficient was successful. The 1908 Model T sold for \$850. In 1920 the price was \$440. Finally, by 1925, a Model T could be purchased for \$290.<sup>6</sup>

By contrast, Alfred P. Sloan Jr., as head of General Motors (GM), adapted to the changing business landscape. He devised a business strategy that recognized, among other things, that the car market was becoming a trade in business and that automobile ownership was becoming a reflection of both social status and personal taste. In response, Sloan crafted a business strategy that recognized and exploited the forces of the market. Acquiring a series of auto manufacturers, he created brands that would appeal to various market segments. Customers could start with a Chevrolet and move up to a Cadillac as their level of income rose. Within each of these brands, Sloan offered options that would allow for differentiation within the brands. No longer would customers have to settle for black.

Sloan is also credited with instituting process and control systems that made it possible for this strategy to be effected. While Ford centralized control, Sloan was keenly aware that GM was far too large an organization to effectively centralize decision-making. GM decentralized decision-making, allowing its divisions to operate autonomously within a strict set of strategic boundaries while adhering to a well understood structure of operating rules. In this way, Sloan was able to craft the strategy and set processes in place to implement it successfully.<sup>7</sup>

GM's strategy of a car for every purpose and purse, along with the systems in place to effect it, drove Ford from a 56 percent market share in 1921, to 40 percent in 1925 and finally down to a 21 percent share in 1937. By contrast, GM's market share in 1937 had risen to 42 percent. In second place was the Chrysler Corporation with a 25 percent market share. Had it not been for the fear of attracting the attention of anti-trust authorities, Sloan could likely have driven Ford completely out of business. Instead, Sloan intentionally held GM to less than 45 percent of the domestic market share.<sup>8</sup>

This illustration demonstrates the power of an effective strategy and the precedence effectiveness must take over efficiency. Not until Sloan was able to execute his strategy did he implement the statistical controls and other efficiency mechanisms that bolstered GM's profit margin and added to the success of the company.<sup>9</sup> It is also noteworthy to point out that after years of successful and profitable operations, GM, like Ford, did not adapt its strategy to reflect changes in the business environment. The 1980s saw GM lose market share to foreign auto manufacturers (primarily Japanese). These new entrants understood that consumers were coming to value quality and reduced fuel consumption.<sup>10</sup> Because of this, they were able to enter a market dominated by established players and quickly pull the rug out from under them. This is a compelling reminder that all companies, even those at the top of their game, must maintain constant vigilance, adapt as the world changes, or suffer the consequences.

### **Purpose of the Study**

DoD can derive many lessons from business. In addition to imitating best business practices in such disciplines as accounting and operations, it would be helpful to study DoD business operations using corporate strategy as an analytical framework. This framework is a useful reference for discussing some of the issues above as well as the DoD's outsourcing initiatives. However, DoD outsourcing efforts to date have been wanting. The picture that comes to mind is that of the chaotic telephone systems of Wall Street at the turn of the century — no coherent strategy and too many players. The result (depicted on the cover of this book) is a problem that does not lend itself to an A-76 type solution — finding a source that can string the wire at the lowest cost. Like the rationalization of the telephone industry, a more basic solution is mandated.

Our hypothesis is that ongoing outsourcing initiatives will not result in the necessary performance improvements and changes required to transform DoD to meet the challenges of the 21st Century because these efforts are focused on doing things right versus doing the right thing. We will test this hypothesis by answering the following questions:

- Does a transformation urgency exist?
- Do DoD outsourcing initiatives align with the DoD business strategy?
- Has the A-76 process generated the results expected?
- Has Strategic Outsourcing generated the results expected?
- Have shortfalls resulted from execution problems or are they strategy-related?
- What are the benefits of a new corporate strategy approach?
- Can such an approach be implemented?

DoD needs to look upon itself not through the overused core competency magnifying glass, but from a new, *resource-based view*. Under this examination, DoD derives its competitive advantage not from a set of core competencies, but rather from a collection of unique resources. The choice of strategy is constrained by the current available resources and the speed at which new resources can be acquired.<sup>11</sup> Formulating a strategy that integrates sound processes and smart business decisions will enable DoD to succeed in transforming and driving the right outsourcing solutions.

We will provide an analytical framework for examining DoD from a resource-based corporate perspective and develop an approach to

outsourcing consistent with this corporate strategy. The goal of this report is twofold. First we seek to use this framework to analyze DoD business activities in terms of seeking a competitive advantage. As we will show, this framework provides a unique perspective on how to make DoD more effective and in so doing to create the desired efficiencies. Second, because of the size and nature of the organization, processes must be developed that will drive the desired outcomes. No amount of restructuring will reduce DoD to the point where change can be dictated from the top. Instead, realignment can best be achieved through the decentralization of certain decision rights. We will carefully explore mechanisms to effect a corporate business strategy using measurement and control systems.

### **Department of Defense Business Perspective**

In the course of our research, we have noted that DoD focuses almost exclusively on efficiency (doing things right) when conducting business operations. Almost no emphasis is given to devising effective business strategies or examining efficiencies in terms of a value proposition. Giving precedence to efficiency is largely a reaction to the following:

- unrelenting budgetary pressures;
- execution of public policy; and
- resource allocation processes.

This drive to the bottom line, however, assumes DoD already has an effective strategy and merely needs to fine-tune the operation. This is a poor assumption on three counts. First, without conducting a strategic business analysis, DoD cannot be certain it has an effective strategy. Second, DoD should seek best value and not lowest cost. In other words, DoD should

garner the most performance for every dollar spent rather than spend the least amount of dollars. Finally, in complex integrated systems, aggregate and not isolated efficiencies must be the focus. By ignoring these, there is an inherent risk that tactical pursuit of cost reductions at the business unit level will drive adverse strategic outcomes.

### **Budgetary Pressure and the Drive to Reduce Cost**

In the post-Cold War era, defense planners have been subjected to a great deal of budgetary and political pressure to find areas of potential savings in DoD.<sup>12</sup> This focus on savings stems from the notion that streamlining the Department will free up dollars that can be reinvested in weapon system upgrades and other modernization initiatives.<sup>13</sup> This defined the operating vision. The Department would use the savings within existing accounts rather than increased budgetary authority to fund various procurement programs. Anticipating these savings, a budgetary shortfall or wedge was incorporated into procurement and operating accounts. This wedge assumed projected savings would be realized in full and then applied to correct for these shortfalls.<sup>14</sup>

In addition to squeezing procurement and operating accounts, rounds of base closures were authorized as a mechanism used to reduce infrastructure and free up dollars. While the Base Realignment and Closure (BRAC) process did close down excess infrastructure, it fell short on three counts. First, for political reasons, the process stalled before it could close the infrastructure targeted. During the 1995 BRAC round, the Clinton Administration privatized two bases rather than close them down. This action was widely viewed as partisan, forfeiting Congressional support for the process. Second, BRAC required a degree of environmental remediation that was unanticipated and

costly. For BRAC rounds completed thus far, clean up costs are likely to exceed \$11 billion.<sup>15</sup> Finally, BRAC planners projected significant revenues from land sales, but the number of acres sold and the amount of proceeds were far less than anticipated. For example, in 1990, DoD estimated that the sale of property on military bases closed by BRAC 1988 could raise about \$2.4 billion in revenues. In fact, DoD only received about \$65.7 million in revenue from land sales on those bases between 1990 and 1995. This is because, by statute, these properties must be offered to other government agencies before they are offered for public sale.<sup>16</sup>

It is important to note that this focus on trimming accounts and infrastructure was a tactical and not a strategic move. The focus was on efficiency. Squeezing accounts and BRAC never addressed the question of strategy — *are we doing the right things?* DoD was performing the same functions both pre- and post-BRAC, albeit on a smaller scale.

### **Execution of Public Policy and the Establishment of Strategic Boundaries**

Office of Management and Budget (OMB) Circular A-76 lays out policy that addresses the role of government but in our opinion, relies on a flawed process for implementation. The Circular states that the government will rely on the private sector to provide commercial products and services unless the government can perform those products or services more economically (Appendix A contains the latest revision of the Circular).<sup>17</sup> While this is a global statement, execution of this policy has been delegated to individual commands and activities within DoD. We feel that this is an incorrect approach. Inherent in the development of a sound corporate strategy is the determination of a firm and unambiguous set of strategic boundaries. These boundaries are not strictly a

function of cost and they are not decentralized decisions. Such decisions are of the select few to be made by top management and dictated to the firm.

Like DoD, business strategists are mindful that they have limited resources and numerous opportunities. Unfortunately for DoD, this is often where the similarity stops. For the business strategist, success hinges on making the best use of available resources, not wasting them on initiatives that do not support the business strategy. To this end, a sound business strategy must include specific boundaries beyond which the organization will not go. These strategic boundaries are essential to defining the scale, scope, and positioning of the business.<sup>18</sup>

Limits to scale and scope are critical. While there are advantages and economies to horizontal and vertical integration, there are also costs that must be addressed.<sup>19</sup> Among the most quantifiable are the costs of maintaining fixed assets (i.e., infrastructure) and the costs of governance (i.e., the administrative hierarchy). While, in the long run, fixed assets can be reduced incrementally in proportion to the level of operations, governance costs typically do not vary proportionally with operational cost.<sup>20</sup> Production facilities and the related infrastructure may often be reduced, but home office staffing remains the same or, in some instances, increases. This trend exists in both the public and private sector. However, in the public sector, this trend is often exacerbated by incentive structures unique to government.<sup>21</sup> This also applies to DoD. One need take only a cursory glance around DoD to observe administrative commands staffed with individuals who are tasked with controlling the functions of integrated systems. While the production structure has decreased, the policy structure has not kept pace. During the draw down of the 1990s, the number of soldiers, sailors, airmen, and marines

declined by one-third while the number employed by headquarters fell by just 18 percent.<sup>22</sup> Often there is a compelling business rationale for vertical and horizontal integration; and often there is not. Absent a compelling reason, when the costs of the bureaucracy exceed the economic benefits, DoD does not create value — it removes it.

There are other costs of integration that are more difficult to measure but nonetheless worthy of consideration. While these will be explored extensively in Chapter Three, there is one metric that — while difficult to quantify — should be at the forefront of any discussion of strategy. That metric is Return on Management (ROM) defined as:

$$\text{Return on Management} = \frac{\text{Amount of productive organizational energy released}^{23}}{\text{Amount of management time and attention invested}}$$

By diversifying into many activities, ROM is diluted. Putting processes in place that require installation commanders to undergo numerous A-76 competitions increases the denominator of this equation without a commensurate increase in the numerator. By not dictating clear strategic boundaries and the systems to enforce them, DoD ensures it will not leverage its management talent — this most scarce of all resources.<sup>24</sup> Perhaps Michael Porter stated it best: “Being all things to all people is a recipe for strategic mediocrity and below-average performance, because it means that a firm has no competitive advantage at all.”<sup>25</sup>

We are fully cognizant of the political difficulties inherent in setting strategic boundaries, or more to the point, deciding what functions to

do in house and what functions to outsource. However, the issue goes beyond outsourcing decisions. Those decisions are made after the fact. In other words, present outsourcing decisions are a direct result of past integration decisions. In the course of our research, we have noted that DoD's overwhelming predilection is to perform new functions internally rather than to look first to the market. The Department activities are standing up functions on a routine basis while at the same time they are undertaking A-76 type studies. Unless a defined and enforced set of strategic boundaries is instituted, we see this trend continuing.

### **Resource Allocation**

In addition to the pressures of falling budgets and execution of OMB Circular A-76, resource allocation within DoD drives behavior that makes implementation of any integrated strategy difficult. By running elements within the Department as cost centers rather than profit centers, the government fosters behavior that concentrates on acquiring resources rather than creating a return on assets, especially capital. Add to this a year-to-year budget cycle that rewards the use of resources rather than their conservation, we have before us a system driving behavior that should come as a surprise to no one.

As stated earlier, we fully understand political realities and the difficulties involved with changing government resource allocation policies. However, it is worthwhile to discuss the behavior these policies drive and the outcomes and limitations they suggest. In the context of a sound analytical framework, one can discuss not only better strategies for DoD but also the confines inherent in the current structure of the Department.

### **Strategy Drives Structure**

Building on themes of strategy development and implementation, we will show that strategy drives structure and related outsourcing decisions. A sound corporate strategy that yields competitive advantage will dictate what functions should be performed internally and what functions should be performed by activities outside the firm. As stated earlier, this is in stark contrast to A-76 and other cost/efficiency-driven approaches. Structure should not drive strategy. Strategy should drive structure. This is what we mean by doing the right things.

### **Overview of the Report**

Chapter One explores the geo-political landscape and business environment confronting DoD at the dawn of the 21st century. We explore the evolution of DoD and the private sector through various historical events as well as the opportunities available in the information age. In the past fifteen years the power of information technology has transformed whole industries, moving them from monolithic vertical structures to more responsive, disaggregated, horizontal structures to virtual organizations that blur traditional organizational boundaries.<sup>26</sup> We believe this technology offers many opportunities for similar transformations within DoD.

Chapter Two defines the terms outsourcing and corporate strategy. We examine the evolution of private sector outsourcing over the past ten years. In addition, we describe methodologies firms use to develop successful corporate strategies. We will focus particularly on company resources and how they are leveraged to create value. This chapter draws extensively on current literature on corporate strategy and cites several examples of firms that have used these approaches to carve out dominant market positions.

Chapter Three examines how industry makes outsourcing decisions in light of the business strategies that they have developed and how, once those decisions are made, they are implemented. Additionally, we examine how the value chain is tied together once the structure is defined. This includes a detailed description of market structure and internal governance mechanisms. In particular, this highlights how strategy affects structure and related outsourcing decisions as well as the systems and processes used to achieve goals and strategy. This is significant because, no matter how efficiently information flows, large organizations cannot be effectively run on a centralized command and control system. Instead, systems must be put in place that drive the organization to effect strategy successfully while allowing for the decentralization of decision rights.

By contrast, Chapter Four is a detailed look at DoD cost-focused approaches to outsourcing. We carefully examine OMB Circular A-76 and variants of this approach to outsourcing, along with the legislative impact of the Federal Activities Inventory Reform Act (FAIR) and the Government Performance Results Act (GPRA) (both acts are contained in Appendix B). This discussion includes A-76 implementation and its subsequent impact. Particular attention is given to the financial goals and assumptions that drive aggressive A-76 studies.

Chapter Five addresses why the results of A-76 outsourcing initiatives have fallen short of expectations and why further pursuit of this strategy will generate only marginal results. More important, we examine how this focus on efficiency may bring about adverse consequences, eroding business advantages that DoD has long held and removing value. In this chapter we cite survey data to address not only the indicators (demonstrating that A-76 is a flawed business strategy) but also the underlying causes. These causes include a review of systems,

processes, and culture that must be addressed before implementing any strategy.

Chapter Six describes how to build effective strategies around the tenets of the Department, and processes that will drive the outcomes DoD is seeking. This chapter draws on the previous chapters in order to show how the new framework can be used to evaluate the business functions in DoD and formulate strategies that will leverage critical resources to the Department's advantage. This includes the construction of a strategic decision model and the mechanisms that can be applied to effect the desired outcomes. Chapter Six also addresses how to implement strategy once it is formulated. The most effective strategies are of little use if they are never successfully implemented. Unlike a corporation (which has relatively wide latitude to implement policies and relatively few stakeholders to challenge them), DoD exists in an environment that makes change especially difficult. Here we suggest methods by which corporate strategic decisions can be implemented in ways that are politically viable and self-reinforcing.

Finally, Chapter Seven draws conclusions and recommendations as well as areas for further research. We hope these will be acted upon.

### **Objective of this Study**

It is our sincere hope that this publication fosters much needed discussion among those who are involved in DoD business operations, especially those individuals responsible for developing policies and leading change. By stepping back and examining an issue from a new perspective, people may see opportunities that might not have been evident before.

***"The real voyage of discovery is not in seeking new lands but in seeing with new eyes."***

**— Marcel Proust**

# **1**

## **BUSINESS AND GOVERNMENT IN THE TWENTY-FIRST CENTURY**

*"The times they are a-changing."*

**Bob Dylan**

### **Introduction**

This report begins with an examination of the political, business, and technological landscape. We do this because, just as evolution tends to reward species that successfully adapt to the environment and punish with extinction others that do not, businesses too are rewarded for successful strategic adaptations. Conversely, companies that do not have sound strategies or fail to successfully adapt to the changing environment are likely to go the way of the dinosaur.

In this chapter, we cover three areas. First addressed are the changes that have taken place in the political and economic landscape. These changes have had a significant impact on the structure and health of the defense industry. The vitality of this industry is of strategic interest to the Department of Defense (DoD) and given DoD's monopsonistic position in the market, its actions have direct consequences on these critical suppliers.

Next we explore the technological revolutions taking place and the impact of emerging technologies on the business environment. This examination is done using comparisons with historic innovations that transformed the economic landscape. In retrospect it is easy to see the impact of technological forces, but often the power of these forces weren't understood in their day. That is much the case for today's advances in information technology (IT).

Finally we examine modern business models that can help organizations take advantage of these advances. Through information flow, companies are now able to respond nearly instantaneously to the needs of individual customers and to run business enterprises that extend well beyond the physical limits of company assets. These models are redefining how business is transacted in much the same way that gunpowder redefined warfare.



## Global Transition and Challenges

The past 15 years have been marked by dramatic changes in the political, economic, and business landscape. This period brought us the end of the Cold War, the rise of the information economy, and a transformation of business processes. Fifteen years ago, the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO) did not exist, there was no common European currency, and companies with names like Digital Equipment Corporation (DEC) graced the top of the Fortune 500 list.<sup>1</sup> Today NAFTA, WTO, and the European Union (EU) are accelerating the globalization of business. DEC fell from supremacy and was subsequently acquired by Compaq, a company that was incorporated in 1982 when DEC reigned supreme.<sup>2</sup> In the past 15 years, the Dow-Jones Industrial average has risen at a faster rate than during any other period in history and business structures are rapidly changing from centralized hierarchical frameworks to virtual organizations where information technology is rapidly diminishing the importance of organizational boundaries.

Fifteen years ago, containing the Soviet Union held sway over U.S. military doctrine. A wall separated East and West Berlin and the Warsaw Pact was a very real threat to Europe. Fifteen years ago, few Americans had heard of Tiananmen Square. Hong Kong was a British possession, and China, with its communist economy, was not widely viewed as a potential economic powerhouse. Fifteen years ago, North Korea did not have a ballistic missile program, Iraq was viewed as a bulwark against an aggressive Iranian regime, and the U.S. had a sizeable presence in Panama.

Today the Soviet Union is found only in history books, East and West Germany are united, and Poland is a member of the North Atlantic Treaty Organization (NATO) along with

Hungary and the Czech Republic (a country that did not come into existence until 1993). Americans now cite the military crackdown at Tiananmen Square when discussing Sino-American Relations. Hong Kong is no longer under British rule, and an increasingly capitalist China is rapidly growing into an economic powerhouse. Today North Korea and Iran are classified as rogue nations with ballistic missile capabilities, the U.S. views Iraq as the principle threat to Middle East peace, and Panama (using a Chinese company) operates the Panama Canal and exercises sovereignty over the Canal Zone.

Just as the political climate has changed, so too has the business and economic landscape. Fifteen years ago, the Internet was a small global network, its use limited to scientists and the military.<sup>3</sup> Companies like Netscape, America Online (AOL) and Yahoo! did not exist. Apple Computer was dominant in the home computer market, California's prosperity was largely driven by the Aerospace Industry, and Silicon Valley was synonymous with research, not economic power.<sup>4</sup>

Today of course, access to the Internet is widespread. Netscape, Yahoo!, Amazon.com, AOL, and dozens of other Internet-related companies are household names, and companies like Toshiba, Dell, and Compaq have eclipsed Apple.<sup>5</sup> Aerospace and Defense Industry restructuring and relocation have eliminated nearly 200,000 jobs, mostly in Southern California.<sup>6</sup> Despite this, the Silicon Valley has fueled California's economic rise to become the sixth largest economy in the world.<sup>7</sup>

This chapter provides an overview of some of these changes, their impact on DoD, and their potential impact on DoD business functions. We provide this insight because understanding the business environment is a critical element to constructing an effective strategy.

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Businesses do not exist in a vacuum. When performing strategic analysis, it is essential to understand the dynamics of the marketplace. This applies not only to private firms but also to public entities like DoD. Second, in order to position a business effectively in the marketplace, it is important for a firm to understand the impact and the potential of technological change. Throughout this chapter, we will highlight some companies that understood these verities and successfully adapted; we will also provide examples of companies that did not adapt and paid the price.

### **End of the Cold War**

In 1988 President Bush endorsed President Reagan's military buildup and pledged to support modernization of the U.S. Armed Forces. The U.S. was on track to continue its Cold War posture. But then something welcome and unexpected happened. In November of 1989 the Berlin Wall fell. Over the next two years, the Soviet Block dissolved. By the end of the third year of the Bush Presidency, the Soviet Union itself disintegrated.<sup>9</sup> In what seemed like the blink of an eye, the geo-political landscape had been transformed. The Cold War was over.

Victory in the Cold War was a vexing event. While war with the Soviet Bloc was a horrific prospect, this potential conflict had provided defense planners with a fixed adversary and a stable focused doctrine. Envisioned was the potential of a vast global conflict and a defense structure designed to wage a vast war of attrition. This model necessitated stockpiles of material and the maintenance of large standing forces ever on alert to engage the enemy on a global battlefield.

Support and infrastructure assembled for this conflict (that fortunately never came) is daunting in retrospect. Consider the following: in 1992, DoD stocked about 2.2 million different

items valued at \$100 billion.<sup>10</sup> This material would be used to support and sustain the wartime requirements of 27 active and 11 reserve Army and Marine Corps divisions, 53 active and reserve air wings (Navy, Marine Corps and Air Force), 324 heavy bombers, and 546 combat ships. In just a few years these figures — material equipment and manpower — would be trimmed by 40 percent.<sup>11</sup>

As the Cold War wound down, however, the U.S. would soon discover the world was not necessarily without conflict or unrest. In August of 1990, Iraq invaded Kuwait and threatened Saudi Arabia. The U.S., along with a multinational coalition, assembled a force that first contained Iraqi forces, then drove them from Kuwait. Operation Desert Shield/Desert Storm was arguably the high point of American military might in the postmodern era. The U.S. had mustered assets for global war on a regional battlefield and Allied forces attained a striking victory. The war also showcased what to the general public were new concepts in warfare — stealth technology, precision munitions, and missile defense among others. Like the geopolitical landscape, warfare itself was changing. The advent of smart weapons and other new technological capabilities meant that war could be waged more precisely. However, these new weapon systems and capabilities came with acquisition costs that would rapidly become unsustainable.

In this and other ways, the end of the Cold War and the allied victory in Desert Storm marked the end of one era and the beginning of another. Military planning shifted from waging global war to engagement in regional conflicts.<sup>12</sup> Defense structure was revised accordingly. The 1993 Bottom-up Review and 1997 Quadrennial Defense Review (QDR) set targets to reflect a smaller force. Table 1-1 illustrates the change in defense structure.

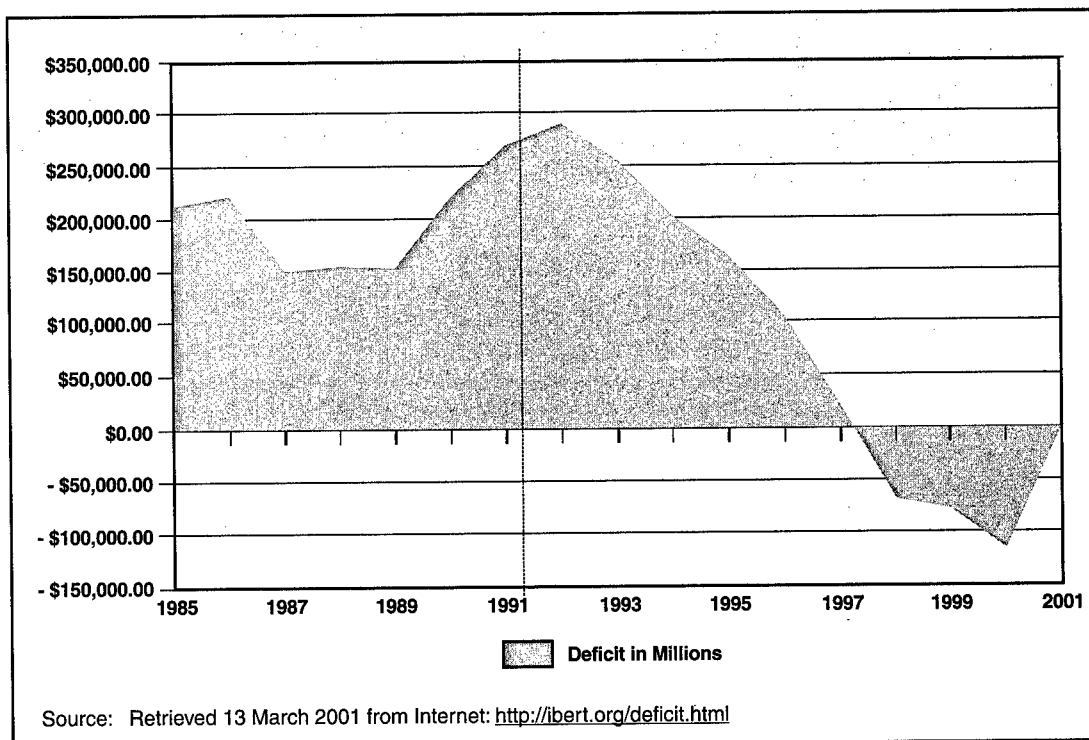
U.S. Defense Draw-down 1999-2000			
Item	Cold War (1990)	2000	QDR Target
<b>Total</b>	2,069	1,385	1,363
	1,128	865	835
<b>Army:</b>			
Active	24	10	10
Reserve	10	8	8
<b>Air Force:</b>			
Active	24	13	12
Reserve	10	8	8
Heavy Bombers	324	90	92
<b>Navy:</b>			
Aircraft Carriers			
Active	15	11	11
Training	1	1	1
Air Wings			
Active	13	10	10
Reserve	2	1	1
Battle Force Ships	546	314	306
<b>Marine Corps:</b>			
Divisions			
Active	3	3	3
Reserve	1	1	1
Air Wings			
Active	3	3	3
Reserve	1	1	1

Source: U.S. Census Bureau, Statistical Abstract of the United States: 1999.

**Table 1-1. The Post Cold War Defense Structure**

The downsized military reflected what was needed to cope with new global realities. After 40 years of living with the threat of World War III, and in the face of looming budget deficits, the U.S. was ready to reduce its defense structure. Envisioned in these reductions was a commensurate reduction in defense budgets. Planned budget reductions would sustain the new force structure and support authorized

procurement and modernization programs. However, faced with soaring deficits, the context of defense budgeting soon changed from a discussion of funds needed to sustain the base force to a discussion of what would be DoD's contribution to deficit reduction. Figure 1-1 shows the dynamic of rising deficits during this period. This came to a head during the 1992 presidential election and guaranteed that



**Figure 1-1. Federal Budget Deficits (1985-2001)**

defense budget reduction would expand beyond what would be needed to sustain the revised military structure.<sup>13</sup>

This meant that budgets would be squeezed beyond the amounts planned to sustain structure and operations. However, while funds were being reduced, operational commitments began to rise. Over the ten-year period from 1990 to 1999, the DoD budget was reduced by 27 percent, manpower was cut by over one-third, and bases were reduced by 10 percent. In this same period, however, deployments and operations increased. Army deployments rose by 300 percent. From 1993 to 1999 Navy deployments increased by 52 percent. Since 1986, Air Force deployments have quadrupled. For the Army, this increased operations tempo was executed with 40 percent fewer people (military and civilian). The Navy has 30 percent fewer ships and the Air Force has lost a third of its people.<sup>14</sup>

With no compensating increase in defense budgets (specifically operations and maintenance accounts), these operations were largely funded out of hide (i.e., tapping into other accounts). As we will see, modernization accounts, which includes weapon system procurement, bore the brunt of the impact. This was to amplify the impact of the new defense structure on the Defense Industry. (Appendix C lists DoD account data by major appropriation.)

### **The Impact of Downsizing on the Defense Industry**

The downsizing of the military and the increasing pressures on the defense budget had implications not only for DoD but also for the defense industrial base. Recognizing this, in 1993, Defense Secretary William Perry summoned America's main defense contractors to a meeting that has gone down in legend as "The

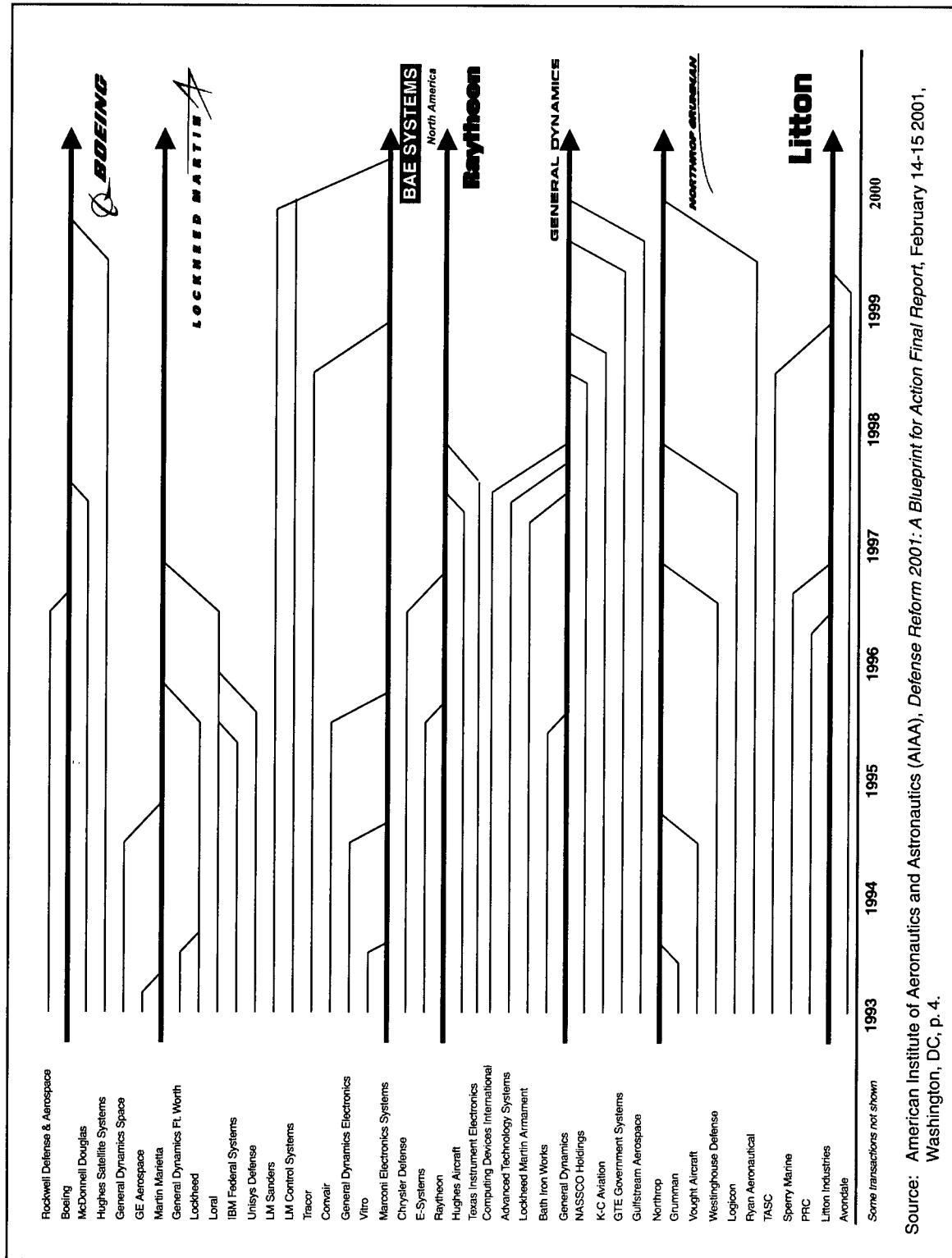


Figure 1-2. Consolidation of the Defense Industry

Last Supper.” With the end of the Cold War, the military procurement budget was being cut in half; the administration made it clear that there was not enough business to sustain the current industrial structure. The result was that 32 defense companies consolidated into nine and then to seven.<sup>15</sup> Figure 1-2 illustrates the magnitude of this restructuring.

This structure reflected the realities of the new business environment and a strategic realignment of the industry. The primary goal of consolidation was to remove excess capacity so that the remaining players could take full advantage of economies of scale and scope.<sup>16</sup> For those that chose to stay in the defense industry, the strategy was to acquire and integrate. Other firms made decisions to divest and reposition their firms. These were critical strategic decisions. Over the past decade, virtually every tier of the industry from major prime contractors to suppliers has consolidated through a series of mergers and acquisitions that have led to far fewer but larger and more vertically integrated companies.<sup>17</sup> The environment had changed and industry adapted accordingly.

This of course changed the economic and competitive landscape. The decreased number of

suppliers has led to increasingly oligopolistic competition among the remaining firms. As competition moves from several to a relatively few firms, there are two critical fall-outs. First, as competition narrows, the power to set price is increasingly in the hands of the supplier. Offsetting this is the power of Government as the sole (monopsonistic) buyer. To exercise this power, the Government relies on law and regulation to limit the price that contractors can charge (e.g., Cost Accounting Standards, the Federal Acquisition Regulation (FAR), Weighted Guidelines, etc.). Enforcement of these governance mechanisms represents a cost to both the supplier and the buyer. This is an example of strategic behavior between buyer and seller. Often these strategies lead to situations in which the two players are worse off than if an alternative strategy were used, such as eliminating governance structures and sharing the benefits (see Figure 1-3, Prisoner’s Dilemma).

The second fall-out is that sellers behave strategically. This is because, in oligopolies, the actions of individual players affect the profits and welfare of all the players. This drives behaviors that are designed to avoid a worst case risk but are not optimal for the sellers, the buyer,

The Prisoner’s Dilemma describes a situation where two players each have a dominant strategy, but playing this pair of strategies leads to an outcome in which both sides are worse off than they would be if they cooperated and played alternative strategies. Imperfect information or a lack of information causes the dilemma.<sup>18</sup> For example, imagine two persons accused of a crime (which they have committed) and separately interrogated. If neither confess, they will be convicted of a lesser crime that is easily proven giving them each a one-year sentence. If one confesses and the other stays quiet, the confessing prisoner will go free and the one who stayed quiet will receive a ten-year sentence. If both confess, each prisoner will receive a five-year sentence. Clearly, both are collectively better off if they stay quiet, but lacking information, each is likely to confess to avoid ten years of imprisonment.

Source: M. Katz and H. Rosen, *Microeconomics 2<sup>nd</sup> edition* (Burr Ridge, IL: Irwin Press, 1994), p. 557.

**Figure 1-3. Prisoner’s Dilemma**

or the players as a whole. In Chapter Two we will introduce Game Theory and in Chapter Three we will apply this discipline to further explore these behaviors and discuss strategies to attain optimal outcomes for all players.

### The Post-Consolidation Defense Industry

Declining defense budgets and inconsistent acquisition policies have had an adverse impact on the Defense Industry.<sup>19</sup> The Department's procurement spending is down significantly. In constant fiscal year (FY) 2000 dollars these accounts are down from \$96.7 billion

in 1990 to \$53 billion in 2000.<sup>20</sup> Figure 1-4 illustrates this decline across major defense budget categories during the 1990s.

Perhaps more important, the nature of the Defense Department's budgetary process and the political environment in which DoD operates has provided an unstable landscape for industry players to operate in. Consider these excerpts taken from recent press reports:

[Greg Schneider; Thomas E. Ricks, "Fighter Jet Faces New Scrutiny; Budget Crunch, Changing World Threaten

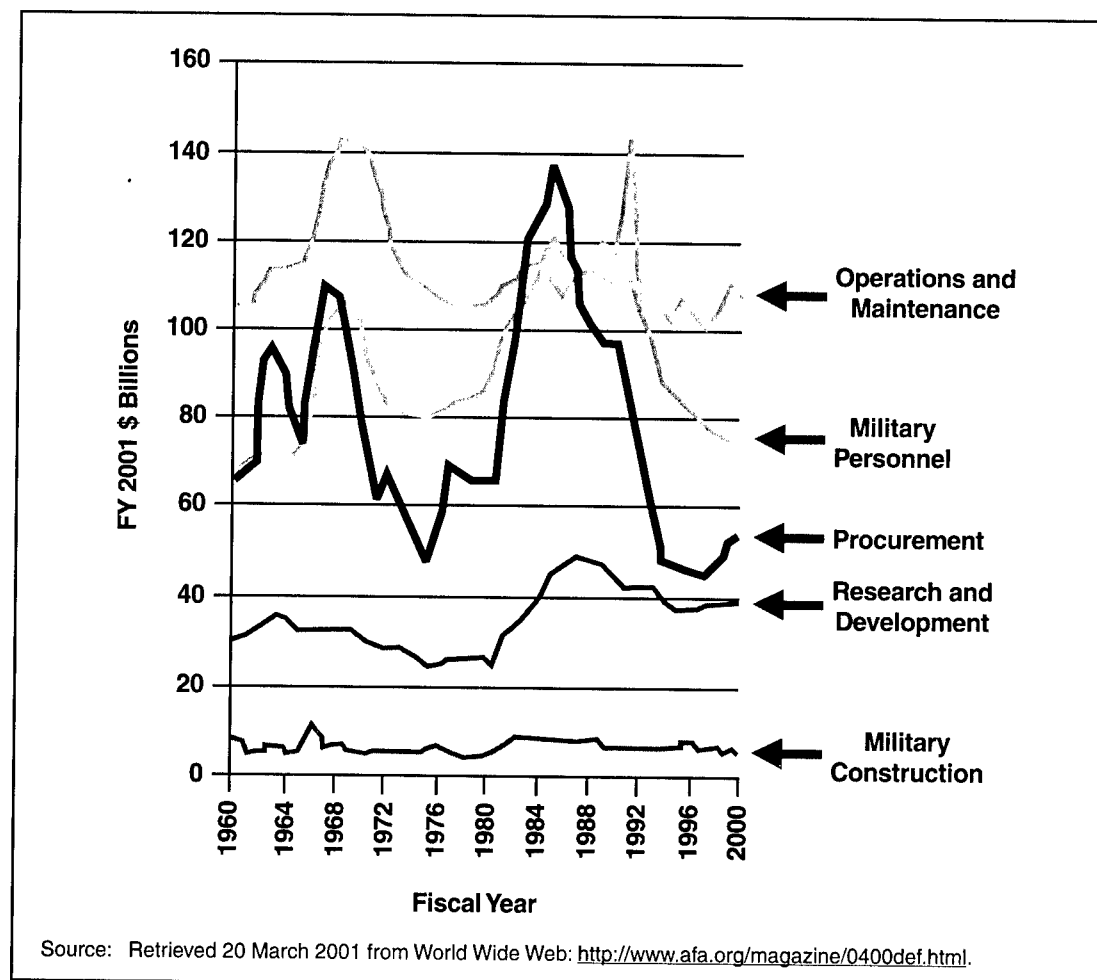


Figure 1-4. Spending Across Major DoD Budget Categories (1960-2000)

\$200 Billion Project,” *Washington Post*, Dec 28, 2000, p. E.1] Pentagon insiders say that Marine aviation is so troubled that the Marines may not have either the energy or standing to complain about changes in the JSF program. In addition to the Harriers, the Marines are having high-profile trouble with their V-22 Ospreys, hybrid aircraft that take off and land like helicopters but can fly like airplanes by tilting their rotors forward. Two of the Ospreys have crashed this year, killing a total of 23 Marines. If the Joint Strike Fighter program were altered, Pentagon insiders predict, the Marines would grumble but ultimately just limp along with the frequently grounded Harriers as best they could, and maybe fill whatever gaps developed by buying additional copies of the F/A-18 E/F. The Air Force would rejoice and buy more F-22s. And the Navy would shrug and happily increase its purchases of the F/A-18 E/F. Of course, shifting defense dollars away from the Joint Strike Fighter to other programs would not necessarily disrupt the near-term bottom lines of contractors. Lockheed Martin could sell upgraded F-16s for a few more years; Boeing would sell a few more F/A-18s; and Raytheon Co. and Northrop Grumman Corp. could equip those planes with the electronics gear they are currently developing for the Joint Strike Fighter.

[Mark Thompson, “Another downed Osprey has Marines defensive,” *Time*, 25 December 2000 – 1 January 2001, p. 44] The accident couldn’t have come at a worse time; it led to the fleet’s grounding and compelled the Pentagon to postpone a decision on beginning

full scale Osprey production. Within hours of the crash, Defense Secretary William Cohen and Congress announced probes of the program. As if that wasn’t enough trouble, the incoming Vice President is Dick Cheney, who tried to kill the program a decade ago when he ran the Pentagon.

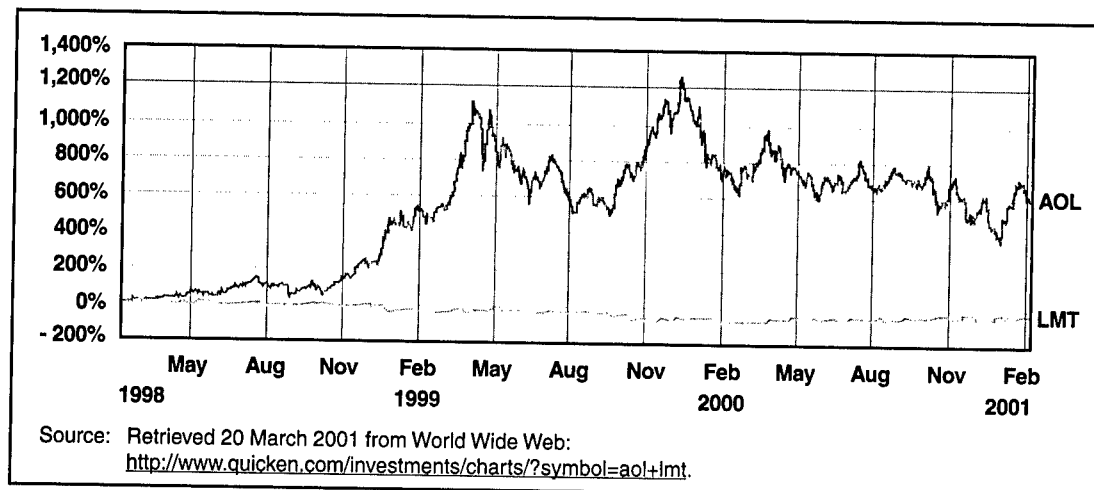
[Sig Christenson, “Lackland Contract Under Fire Way Pact Awarded Drawing Attention,” *San Antonio Express-News*, December 19, 2000, p. A1] The Pentagon was poised late Monday to launch a probe into the way the Air Force awarded a \$336 million, five and a half year support services contract at Lackland Air Force Base. A Defense Department spokesman vowed Monday to “satisfy outstanding concerns of six Texas lawmakers about the deal.”

Such reports hardly inspire confidence in the affected firms, the industry, or the investment community. For this and other reasons we will explore, DoD is far from an ideal customer and the Defense Industry far from an ideal target market. This conclusion is driving market behaviors that have a direct and discernable impact on DoD. In the following section, we will examine these market behaviors and illustrate their systematic impact.

### **Impact on Equity Markets**

A lack of profit or predictability are two of the reasons that defense contractors have seen their market capitalization evaporate. For a company like General Dynamics or Lockheed Martin (LM), DoD might be their major customer, but for shareholders in these companies, this isn’t the only place for their investments.<sup>21</sup> Figure 1-5 compares the three-year stock performance of AOL with that of Lockheed Martin.





**Figure 1-5. Stock Performance of Lockheed Martin and America Online**

LM is the nation's largest defense contractor with \$25.3 billion in annual revenue, about 60 percent of it from military sales. Recently, after a dismal five-year performance, its shares have surged 72 percent to a recent high of \$37. Part of the stock's strength lately is traceable to the company's announcement that earnings are expected to grow 25 percent to 30 percent in 2001. At the time of writing, shares were trading at 26 times those expected earnings.<sup>22</sup> This may seem like good news, but the performance pales in comparison to new economy giants like AOL.

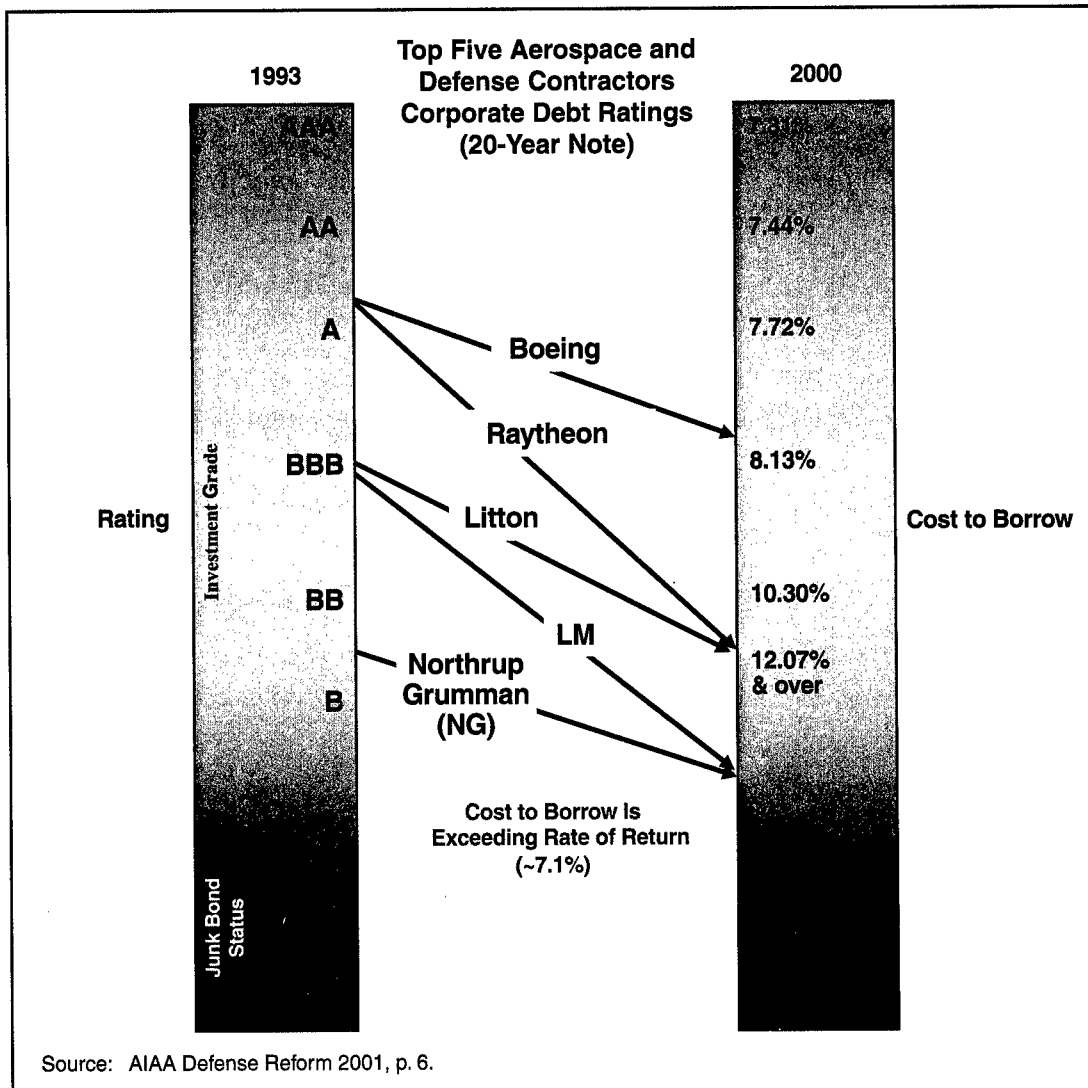
The simple fact is that other opportunities in the equity markets make the Defense Industry relatively unattractive. Inevitably, this has driven investment capital to other more lucrative market opportunities. While some readers might be inclined to think that the ability of defense contractors to attract investors is not a DoD problem, such issues have a real strategic impact on DoD. The ability to attract financial resources in the equity markets is a critical factor for companies that wish to remain robust and competitive. It can also be argued that an enfeebled Defense Industry has a potentially negative impact on the nation's ability to mobilize rapidly in the event of war.

### Debt Markets

Absent the ability to attract capital through equity, firms must turn to debt markets to finance operations. However, the debt markets are equally unforgiving of low or inconsistent performance. As a result, bond ratings for the industry are sliding. With this comes an increase in the cost to borrow. Figure 1-6 shows the erosion of bond ratings for each of the top five defense firms.

Equally distressing, the debt loads of these companies have risen dramatically. This is depicted in Figure 1-7.

Rising debt levels and lowered credit ratings increase the cost of capital and the return investors expect for their investments. Absent high returns, more equity is driven from the industry. The effect of all this is that market risks are increasingly born by DoD. This translates into higher prices for weapon systems. Higher prices mean these systems are less affordable; therefore, fewer will be procured. Overhead costs are then allocated over a smaller number of sales, further driving up price in a vicious circle.



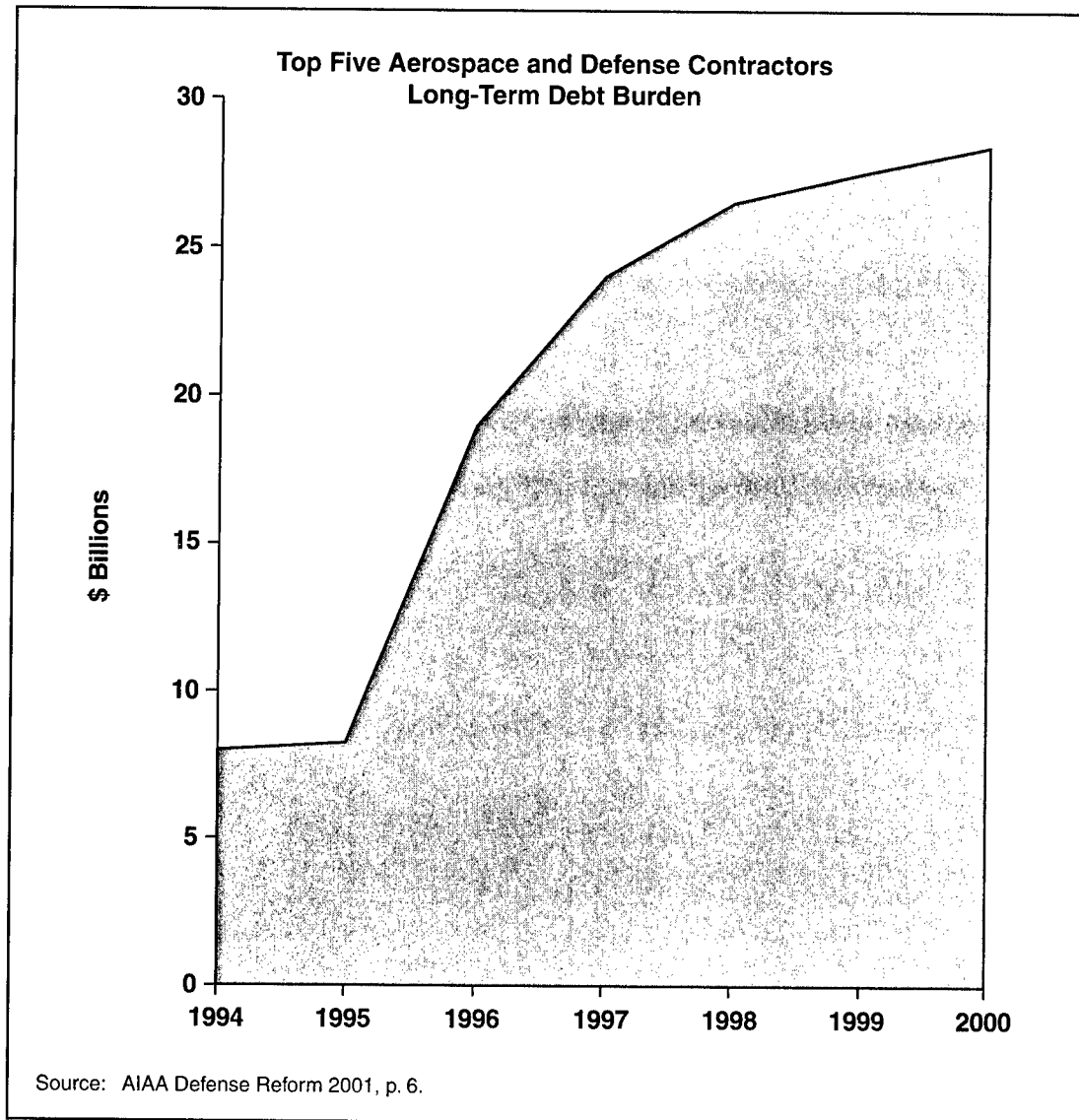
**Figure 1-6. Bond Ratings**

For this and other reasons, reforming profit policies was a top goal for the Clinton Administration during its final year in office. In the wake of a mid-1999 drop in Defense Industry stock prices, DoD officials feared that many leading firms on which the nation depends for its needs were ripe for break up. The price collapse at the time was driven by poor performance at such leading firms as LM and Raytheon, which have been working to return to financial health. Recommendations for new

policies were contained in a Defense Science Board (DSB) study completed in April 2000.<sup>23</sup>

### **Trends and Opportunities in the New Global Economy**

As defense industries and manufacturing in general were becoming unattractive investments over the past fifteen years, new high-tech elements of the global economy are on the rise. This shift is driven by underlying



**Figure 1-7. Defense Industry Debt Load**

changes, specifically computer and information technologies. This in turn has revolutionized the ability of businesses to transact and share information. Understanding the power of the enabling technologies and their impact on the economic landscape is the key to understanding the transformation taking place in business today and the potential impact of these changes into the future. To aid in this understanding, we offer a brief historical examination of

technological change and how those changes affected business and the economy.

Just as the Industrial Revolution changed the world economy, the current technological revolution is echoing and amplifying the original impact that industrial mechanization had on the business, political, and social environment. Indeed, some have theorized that industrial revolution is not a singular event but rather a

recurring theme.<sup>24</sup> Understanding this theme is fundamental to understanding the power of the revolutionary changes that are impacting today's business environment. Furthermore, understanding this environment is essential to formulating an effective business strategy.

Additionally, just as revolutions in technology recur, the refinement of that technology continues over time. Strategists must not see only the capacity of any given new technology, but they must also grasp the potential of the technology in order to lead their organizations in directions where they can move quickly when technological potential is realized. Business strategists must also define and position their businesses in light of the impact of technological change. As Theodore Levitt advised in "Marketing Myopia," U.S. railroad companies defined their business too narrowly. They thought they were in the railroad business when they should have realized they were really in the transport business.<sup>25</sup> Railroads, of course, suffered from this narrow definition. Similarly, Curtiss-Wright thought they were in the radial engine business when they were in fact in the aircraft engine business. The result — Curtiss-Wright never made significant investments in jet engine technology. By contrast, Pratt and Whitney, another radial engine manufacturer,

understood they were in the aircraft engine business and that under this definition they needed to embrace and invest in jet engine technology. This change in technology and the ability to define and position a business also allowed General Electric (GE) to enter the market successfully. By examining the parallels between the power generation turbines it was producing and how this technology was applied in jet engines, GE understood that the turbine business, by definition, encompassed the jet engine business. Today, GE and Pratt dominate the aircraft engine market.<sup>26</sup>

### **Recurring Technological Revolution**

The First Industrial Revolution was characterized by automation that replaced labor with capital. No longer did items have to be produced by hand. Now they could be produced rapidly by machines. This was a revolution in the ability to transform material from raw inputs to finished goods. The next revolutionary change came with the advent of the steam engine and the locomotive. Now these goods could be rapidly moved by machine. This was a revolution in the ability to transport. Today, enabled by the advent of the computer network, we are in the midst of an equally powerful transformation — a revolution in the ability to

Since the seventeenth century, the standard weapon for the infantryman was the smooth bore musket (and later the rifle). Prior to the Industrial Revolution, these weapons were handcrafted and parts were not interchangeable. As tooling improved, this changed. In the United States, the Springfield Armory is credited with being the first arms manufacturer to produce to a sufficient standard where muskets could be disassembled, their parts mixed and then reassembled into functioning weapons. This represented a giant step forward and was quickly imitated. Now the presence of a few spare parts could quickly put a musket back into service where before the weapon would be rendered useless.<sup>27</sup>

Source: J. McPherson, *The Battle Cry of Freedom* (Oxford, UK: Oxford University Press, 1988), pp.15-16.

**Figure 1-8. Standardized Production and the U.S. Military**

transact. In the following paragraphs we will explore the impact and consequences of changes in the ability to transform, transport, and transact.

The impact of this First Industrial Revolution propelled manufacturing economies forward in ways that were then unimaginable. Shops that could produce a small quantity of hand-crafted goods were displaced by factories that could produce large quantities of standardized items. The Industrial Revolution made possible the mass reproduction of objects and, in a virtuous cycle, produced the wealth needed to purchase them.<sup>28</sup> Whole industries were changed including arms manufacturing (see Figure 1-8, Standardized Production and the U.S. Military). By the mid-nineteenth century the impact of mechanization was in full swing.

Still, this great expansion of production capacity remained isolated to specific geographic areas with sufficient populations that would provide a market for these goods. With no way to economically transport large quantities of material except by direct water routes, the Industrial Revolution was predominately a localized event. Regional economies and regional markets predominated.

This changed with the advent of rail transportation. New, heretofore unreachable markets were opened, accelerating the economy and the economic motivation to produce. In this country, with the completion of the Transcontinental Railroad, goods could travel from coast to coast in a matter of days instead of months. So too could people, a fact that was not lost on military planners (see Figure 1-9, The Transcontinental Railroad and U.S. Military Strategy). Rapid, effective, and economic transportation reduced freight transportation costs and made the price of consumer goods and industrial goods more affordable, further accelerating a growing economy.

Rail transportation also accelerated the concentration of manufacturing in what has been referred to as the Second Industrial Revolution.<sup>30</sup> By the 1890s, firms seeking to exploit economies of scale were consolidating operations. This is the era of the “Robber Barons” and the emergence of manufacturing powerhouses like Ford and DuPont. The period was also characterized by the emergence of national economies that replaced local economies. No longer were consumer goods produced in close proximity to the consumer. Now, they could be produced across the country and delivered locally.

The United States Army was quick to see the potential that railroad transportation offered, especially in the western territories. Prior to the building of a railroad network, the Army had planned to build and outfit an extensive fort system, each post having responsibility for a defined geographic area. This, of course required investments in materials and manpower both of which the post Civil War Army had very little. General William T. Sherman saw that the railroad could move soldiers and supplies rapidly over a wide geographic range, eliminating the need for an extensive system of forts. With this in mind, Sherman did all he could to support the construction of the Transcontinental Railroad, visiting the Union Pacific work site several times a year and keeping in close correspondence with Grenville Dodge (Chief Engineer of the Union Pacific).<sup>29</sup>

Source: S. Ambrose, *Nothing Like It in the World* (New York, NY: Simon and Schuster. 2000), p. 215.

**Figure 1-9. The Transcontinental Railroad and U.S. Military Strategy**

This business model powered the American economy throughout most of the 20th century.<sup>31</sup>

### **The Revolution Continues**

We are now in the midst of a Third Industrial Revolution.<sup>32</sup> This revolution is enabled in large part by information technology and the impact it is having on the ability to transact business across geographic and political boundaries. This coupled with the reduction of tariff barriers has accelerated the expansion of a global economy that is rapidly diminishing the importance of and replacing individual national economies, as it expands (see Figure 1-10, The Fall of Tariff Barriers). Just as railroads reduced transportation costs and opened up markets, the accelerating power and connectivity of computers is reducing the cost of business transactions from firm to firm and from firm to consumer. This, in turn, has given rise to the Information Economy.

### **The Information Economy**

Just as rail transportation enabled the Second Industrial Revolution to take root, the Third

Industrial Revolution grew from the rich environment of information technology. Railroads made countries and continents smaller places; lines that transmit large amounts of data at the speed of light are quickly transforming the world into a global community. The needs of customers at just about any place on earth can be rapidly communicated anywhere else. However, unlike the relatively slow expansion of railroad service, access to information is expanding at a greater pace than anything ever previously seen.

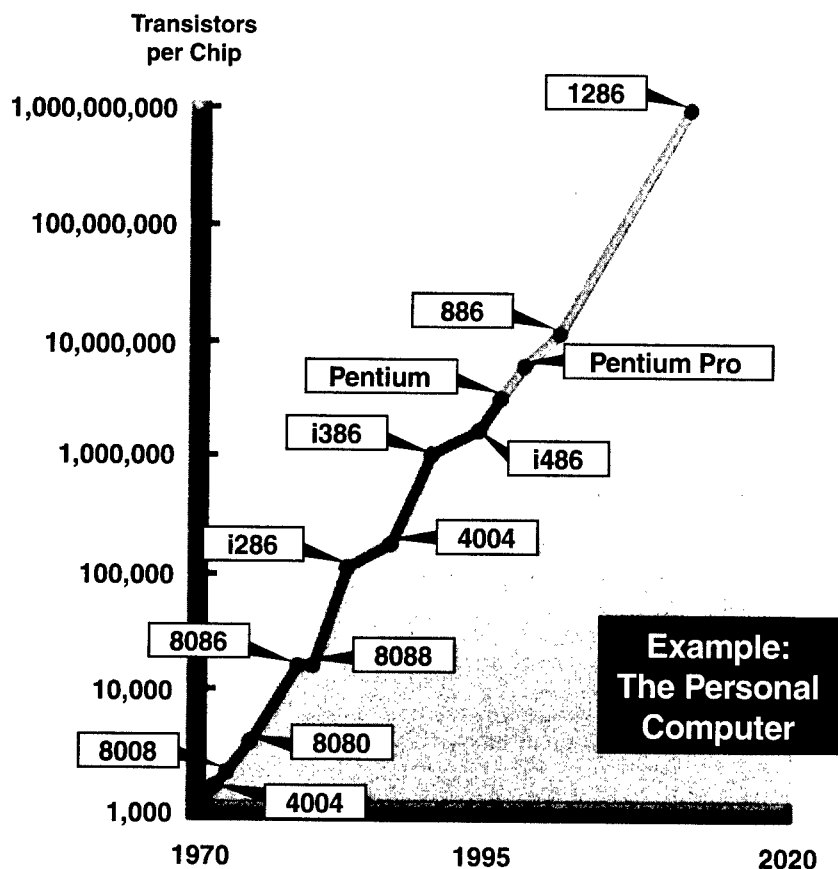
In their day, railroads, driven by powerful economic forces, grew at a dizzying pace, more than doubling the amount of track laid each decade.<sup>35</sup> Today, equally powerful economic forces are driving the growth of the Internet (see Figure 1-11, Moore's Law). In 1993 there were 130 sites on the World Wide Web (WWW). By the year 2000, that number had grown to over 22 million.<sup>36</sup> The Internet economy surged 63 percent in 1999 to nearly \$524 billion, up from \$322 billion in 1998. Jobs related to the Internet increased by 650,000 in 1999 to more than 2.4 million today.<sup>37</sup> The world is going electronic, but why?

Several other factors of course have made globalization possible. Most notably, tariff barriers have dropped, causing a rapid increase in cross-border trade, integrating world economies. In 1960, American Imports and Exports stood at 9 percent of GNP. Today, they stand at more than 25 percent.<sup>33</sup> The expansion of trade has placed economic pressure on American industry. In order to compete globally, American businesses have moved many functions to areas of the world that contribute to their competitive advantage. Operations may be relocated to take advantage of lower labor costs, less stringent environmental regulation, or to better serve a local market. This has resulted in a significant realignment of U. S. Industry. For example, today there are no televisions manufactured in the United States despite the fact that this country produced and perfected the technology. This trend is not specific to the United States. Currently, electronics firms in Japan are moving television manufacturing operations to Mexico and Malaysia.<sup>34</sup>

Source: T. McCraw, *American Business, 1920-2000: How It Worked* (Wheeling, IL: Harlan Davidson Inc. 2000), pp. 144 and 161.

**Figure 1-10. The Fall of Tariff Barriers**

Moore's observation, now known as Moore's Law, described a trend that has continued and is still remarkably accurate. It is the basis for many planners' performance forecasts. In 26 years the number of transistors on a chip has increased more than 3,200 times, from 2,300 on the 4004 in 1971 to 7.5 million on the Pentium II processor.<sup>38</sup>



Just as the ability to transform and transport more efficiently had real and lasting impact on the business models of their day, so too does the rise of technologies that allow for more efficient business transactions. This enhanced ability to process and disseminate information means that the preferences of customers can now be rapidly accessed, organized, and transmitted to all elements of the value chain. This will continue to have a profound impact on the business model and the organizational structures that support them.

Prior to the advent of these technologies, firms used a make-and-sell model.<sup>40</sup> Under this model, businesses would use generic aggregate data to decide what items to design, build, and sell to a customer base. Cycle times were long, product runs steady, and information was processed through hierarchical organizational structures. In this model, resources were tightly controlled via an annual budget process, and bureaucratic governance structures ensured that

activities were efficiently coordinated. A small cadre of corporate officers resided at the top of this structure. Information flowed up to them through the organization and decisions based on this information flowed back down. At the bottom were individual workers who performed tasks assigned to them.

This business model followed a classic structure used by military organizations and adopted by industry. For most of the 20th century, this command and control structure worked quite well, propelling American industry and the American economy to unprecedented levels of prosperity. But this model has obvious drawbacks. Cycle times are slow, deviations from planned production are costly, and the sheer size and momentum of such an organization impose limits on its responsiveness. Like a lumbering supertanker, it takes a great deal of time to change the direction of the organization after the rudder order is given.

“Make and Sell”		“Sense and Respond”	
Annual budget resource allocation is the “heartbeat”		Dynamic, real-time resource allocation is the “heartbeat”	
Glacial change		Real-time change	
Design, build, sell		Sell, build, redesign	
Plan		Act	
Market share		Mind share	
Build to inventory		Build to customer	
Build reliable, complex products and services		Create unimaginably complex products and services	

Source: R. Kaplan and D. Norton, *The Balanced Scorecard* (Boston, MA: Harvard Business School Press, 1996), p. 117.

**Table 1-2.**  
**Contrasts Between the Make-and-Sell and the Sense-and-Respond Business Models**



### From Make and Sell to Sense and Respond

Today successful businesses are transforming into responsive and agile organizations. The power of networked computer systems and their ability to format and move data are dramatically shifting the business model from “make and sell” to “sense and respond.”<sup>41</sup> In their book by the same name, *Sense and Respond: Capturing Value in the Network Era*, Steven Bradley and Richard Nolan show some of the important contrasts between these two models. These are displayed in Table 1-2.

The sense and respond model offers several advantages over the old make-and-sell model. Cycle times are reduced and there is less need for the long, inefficient production runs, the build-up of inventory, and much of the infrastructure required to get the product or service to the customer under make and sell. Under sense and respond, by contrast, the supply chain

is far more efficient and responsive, reducing inventories and freeing up resources. This model also diminishes the need for resource governance and control structures. By sharing information from business to business, the flow of materials can be orchestrated long in advance of the requirement, thereby shortening the ordering period and eliminating the need to import materials in bulk from firm to firm. Information availability within the firm eases scheduling and improves process flow, eliminating waste and dead time (see Figure 1-12, Manufacturing Cycle Effectiveness).

### Impact on the Organization

Perhaps most important, this model is de-emphasizing the importance of organizational barriers and allowing firms to cross those barriers freely, making, in effect, *ad hoc* virtual firms. Put another way, firms can outsource functions and retain the same (or in some cases, enhanced) oversight and responsiveness that

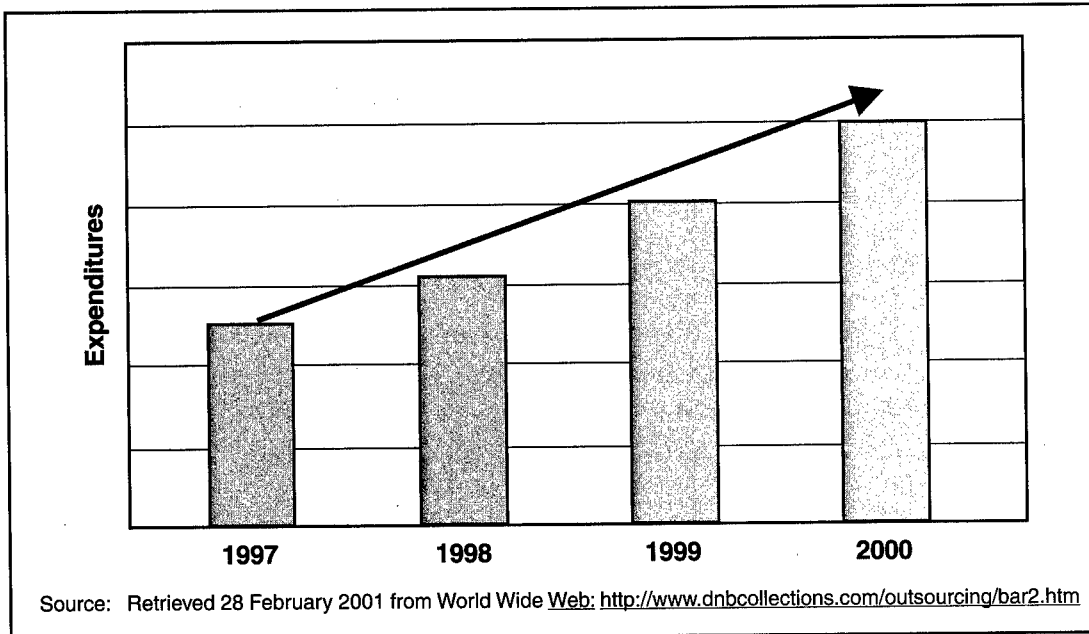
$$\text{MCE} = \frac{\text{Processing time}}{\text{Throughput time}}$$

Where Throughput Time =  
Processing Time + Inspection Time + Movement Time + Waiting/Storage Time<sup>42</sup>

Understanding MCE is the key to understanding the power of an efficient supply chain. When material just sits without being processed, throughput time increases while processing time remains constant. Storage lowers MCE as do unnecessary movement, waiting periods, or any other activity that does not add value. Information technologies shorten transaction time and improve MCE. Customer orders can be instantaneously transmitted via computer, products can be designed and tested rapidly using powerful software programs, and materials can be ordered on line to specification. These actions drive MCE toward a one-to-one ratio.

This also applies to services. By investigating MCE, some lending institutions have moved mortgage approval processes from weeks to minutes. Approving mortgages in 15 minutes would obviously be of value to a customer and provide a competitive advantage over a bank that takes weeks to process the same application.<sup>43</sup>

**Figure 1-12. Manufacturing Cycle Effectiveness**



**Figure 1-13. Global Outsourcing Growth**

they experienced when those same functions were performed in house. Companies like Cisco Systems, known for making the switching routers that are the backbone of the Internet, actually manufacture only a small percentage of those routers.<sup>44</sup> Most manufacturing and assembly is outsourced. Cisco, by controlling the flow of information and not the production process, has risen to be an industry giant.

Similarly, callers to the Kraft General Foods' consumer hotline might think that they are talking to an employee of the company. However, American Transtech (a subsidiary of AT&T) performs this service. This company is designed specifically to support telephone-intensive business processes.<sup>45</sup> Networking technology allows American Transtech to perform an important customer service activity and allows Kraft to concentrate on its core business. To the consumer, the transaction is absolutely invisible. In fact, because American Transtech specializes in and is scored on call center service, customer satisfaction is likely better than

if Kraft performed this function in house. Both Cisco and Kraft have identified a strategic position in the marketplace, made outsourcing decisions accordingly, and used the power of this transactional revolution to make that structure seamless to the customer.

The increasing use of outsourcing is clearly being driven by the expanding demands of the evolving information economy. According to the most recent Dun & Bradstreet Barometer of Global Outsourcing report, outsourcing expenditures were anticipated to surpass the \$1 trillion mark at the end of 2000, becoming "one of the few business activities to ever reach this level of annual expenditure."<sup>46</sup> In fact, global outsourcing has nearly doubled in the past three years, growing at an average of 25 percent a year (see Figure 1-13). Moreover, companies are expanding outsourcing beyond traditional activities such as information technology and manufacturing to areas that directly touch their most important asset — the customer.<sup>47</sup> Through media services, outsourcing has also

The evolution toward the information society and its relationship with outsourcing is obvious in the growth of "new media services." With planned expenditures growing at 18 percent per year, new media services is one of the fastest growing outsourcing areas for the fourth consecutive year. Dominated by electronic commerce and Internet support services and experiencing constant change, virtually the only way to secure access to current best practices and the latest software is through outsourcing to those that keep up with change.<sup>48</sup>

**Figure 1-14. Growth in Outsourcing Linked to Information Economy**

played a roll in the evolution of the information economy (see Figure 1-14). We will explore the evolution in outsourcing more in the next chapter.

#### **Potential for this New Technology for DoD**

Listening to net radio through the computer as we write this, we can, with the click of a mouse, purchase a compact disc (CD) recording of the song that was just played and have the product delivered to the door in a few days or pay a little extra for overnight delivery. Not long ago, such a purchase would have meant a trip to a music store. The savings — at least an hour of time, a retail structure that need not be built, distribution infrastructure that need not be carried as a fixed cost, and a governance and control structure (marketing, etc.) that need not be staffed. So the CD will cost less than if we had

made the purchase at a traditional music store. Furthermore, we can make the purchase at any time of the day or night without regard to traditional retail hours.

Going beyond the CD to the content it contains, we could have the music instantaneously by downloading it (this may happen when the music industry defines itself to be in the music business rather than the CD business). This would further reduce the price we pay by eliminating manufacturing, packaging, and shipping costs from the equation. This capability might open up a whole range of unrealized opportunities for the music business as it has for other industries (see Figure 1-15, Threats or Opportunities).

Expanding on this business model, we could purchase a music file containing songs sequenced to our individual tastes. What is more,

When videocassette recorders began to be sold in great numbers, some in the movie industry saw this as a threat. With movies to play at home, people might not go to theaters. To defend against this, the studios charged high prices for videocassettes, effectively limiting their availability. To their surprise, however, the studios soon found out that movies on video had a complementary effect. People could see upcoming attractions on the tapes and make plans to see a new feature in a theatre. Those that enjoyed seeing a movie might rent the tape or recommend it to their friends. Some would enjoy movies so much they might buy a tape to have permanently. Realizing this, studios reduced the prices they charged for the tapes.<sup>49</sup>

**Figure 1-15. Threats or Opportunities?**

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the business on the other end of this transaction would have access to information showing our individual musical preferences, buying habits, and the timing of our purchases. This would allow them to target not just market segments, but individual customers and generate additional business by forwarding concert information, upcoming recording releases, song previews, etc. No longer is the game aggregate market segmentation. Rather, it is leveraging individual relationships, dramatically extending the value delivered to the customer.

This model also minimizes the importance of investment in infrastructure. The computer screen becomes the store front. The back office is centered on the transmission of data. Demand can be aggregated over a global population. Distribution is not reliant on geographic networks and (in the case of digital products) inventory is nonexistent. This is why Internet providers with ability to create and collect value can provide a high return on invested capital, and why investors are showing interest in these new companies.

This is the power of the Information Economy. Today a computer printer can monitor its ink or toner levels and communicate over the computer it is connected with to companies that will ship replacement cartridges to arrive just before the old ones run out. A supplier can gather and aggregate data about the rate at which ink or toner is used, streamlining the supply chain. This reduces the need for retail outlets and a distribution network, lowers inventory costs, and eases production scheduling. Furthermore, the supplier need not internally develop this capability. It can outsource to a specialist business, paying it a fixed price or (saving time and investment) collaborate with the IT provider providing payment based on a percentage of sales.

Today commuters can drive through tollbooths without stopping. The toll payment transaction is measured electronically using a device affixed to the vehicle and read by a machine on the tollbooth, eliminating the need for a booth operator and allowing the turnpike authority to more accurately measure highway usage, even down to individual driving habits. It is conceivable that in the future, this information could be used to transmit to the individual driver highway conditions tailored to the route he or she normally takes, offering suggestions for avoiding peak hours, alerting the driver to road conditions, offering alternative routes, etc.

Are these examples so far removed from DoD business functions and their support of deployed operational units? The same technology can be used to create virtual agencies that are a mix of public organizations and private firms existing in symbiotic partnerships. Field maintenance equipment can be checked and diagnosed remotely, reducing manpower requirements. Questions about the characteristics of equipment can be answered correctly and instantaneously via links back to the original manufacturer, improving maintenance. The performance of individual equipment by serial number can be tracked, eliminating bad players and improving reliability. A fault diagnosis can be forwarded to a repair facility in advance of the physical arrival of a component, allowing the facility to order materials and schedule the repair, thus reducing turnaround times. And requirements can be identified and shipped in advance of the need reducing order and shipping times.

Such is the potential that exists today. Successful businesses have grasped these concepts and are adapting accordingly. Business functions within DoD can also take advantage of these capabilities in order to formulate strategies that allow them to more effectively perform the

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Department's mission. Just as General Sherman realized the potential of the railroads to solve vexing problems of his day, DoD must see and act on the potential of today's rapidly evolving technology.

### **Summary**

In this chapter we provided a quick snapshot of the political, business, and technological environment facing DoD at the dawn of the 21st century. The Cold War has been fought and won, Europe has freed itself from communist oppression, and the world is fast becoming a global community. Strategies well suited to the past are not well suited to the present. Not long ago, DoD set the technological standard and industry followed. Not long ago, military industrial processes were looked upon with envy. What other organization could field complex systems such as the Polaris Submarine in just two years?

But today it is commercial industry that has taken the lead. Advanced technologies are found in home computers as well as in military hardware. Complex consumer products are developed and go to market often in less than a year — contrast this with weapon system development which can take ten to fifteen years from concept development to fielding. Quality standards are higher, accounting processes more accurate, and responsiveness to customer is far superior. These business models have set a new standard that leaves DoD lacking in comparison. The need to transform is urgent.

The good news is that several models for transformation have already been applied and tested. In the next chapter we will begin to illustrate the techniques the business community uses to evaluate the changing environment and to craft strategies that have transformed hierarchical command and control structures into effective, responsive, and profitable entities. We hold that these techniques and lessons can be absorbed and applied to DoD business functions.

## ENDNOTES

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# 2

## KEY TERMS, CONCEPTS, AND DEFINITIONS

*“What underlies the malaise of so many large and successful organizations worldwide is that their theory of business no longer works.”*

— Peter F. Drucker

### Introduction

In this chapter, we establish common reference points in the treatment of outsourcing, strategy, and the analytical tools used by the private sector in formulating and implementing effective strategies. Industry's experiences to date with outsourcing have been more successful than those of the Department of Defense (DoD), perhaps suggesting that DoD take a different stance to outsourcing implementation. In addition, business strategy is conceptually different from military strategy and so we present a brief overview of business and corporate strategy. Finally, we provide a brief tutorial on five preferred tools in use today for formulating and implementing effective strategies. Later, in Chapter Three, we will illustrate how these are used in the private sector.

### Outsourcing — An Outcome of Strategy

Famed management expert Peter Drucker once wrote in regard to what he terms the *theory of the business*:

The assumptions on which the organization has been built and is being run no longer fit reality. These are the assumptions that shape any organization's behavior, dictate its decisions about what to do and what not to do, and define what the organization considers meaningful results.<sup>1</sup>

Such is the case in DoD today. The Department's assumptions concerning outsourcing and privatization, a type of outsourcing, are no longer valid (see Figure 2-1 for definitions of these terms).

The Department has experimented with outsourcing efforts under the guidance of the Office of Management and Budget (OMB) Circular A-76, and each of the Services (Air Force, Army, and Navy) has tried its own approach, such as competitive sourcing and strategic sourcing (see Figure 2-2 for definitions).

While there is remarkable consistency among these definitions used throughout DoD, the fact



### Outsourcing

- **Defense Science Board (DSB)** – Transfer of a support function previously performed in house to an outside provider.<sup>2</sup>
- **Air Force (AF)** – The sourcing of a new requirement or transfer of an activity that has been performed in house to an outside provider. The Air Force retains full control and responsibility (through service contracts) of the recurring services or functions, which are outsourced.<sup>3</sup>
- **Army** – Outsource...implies that current in-house workload will be contracted out after a study is completed.<sup>4</sup>
- **Navy** – The transfer of a function previously performed in house to an outside provider.<sup>5</sup>

### Privatization

- **DoD** – Privatization is the process of changing a public entity or enterprise to private control and ownership. It does not include determinations as to whether a support service should be obtained through public or private resources when the government retains full responsibility and control over the delivery of those services.<sup>6</sup>
- **DSB** – A type of outsourcing involving the transfer of government assets, to the private sector.<sup>7</sup>
- **AF** – The transfer of ownership of function(s), business assets or both (e.g., government-owned plant and equipment) from the public to the private sector.<sup>8</sup>
- **Army** – Privatization occurs when the government relinquishes ownership and control of an operation by divesting itself of the commercial activity, including the associated real property, and becomes a customer that purchases goods and services from a commercial source.<sup>9</sup>
- **Navy** – A process of changing a public entity or enterprise to private control and ownership.<sup>10</sup>

Figure 2-1. Outsourcing and Privatization Definitions

that each Service has elected to define these terms separately is bothersome. In fact to date these initiatives have not realized the full potential of outsourcing (Figure 2-3 illustrates the gamut of outsourcing options) while, on the other hand, the private sector has reaped significant benefits through outsourcing initiatives.

The private sector has realized that the question is not about *how to do things more efficiently*. Outsourcing is not a management

technique designed to do things differently, but instead it has become a powerful management tool that forces one to reconsider *what to do*. Clearly the private sector's experience with outsourcing over the past ten years has shown that it has evolved to the point that it can fundamentally redefine a business.

In the primer, *Ten Years of Outsourcing Practice: Tactical, Strategic, and Transformational*, Michael F. Corbett & Associates, Ltd., define three distinct phases in the evolution of

### Competitive Sourcing

- **Army** – Competitive sourcing more accurately describes the process that identifies the most efficient provider of a service.<sup>11</sup>

### Strategic Sourcing

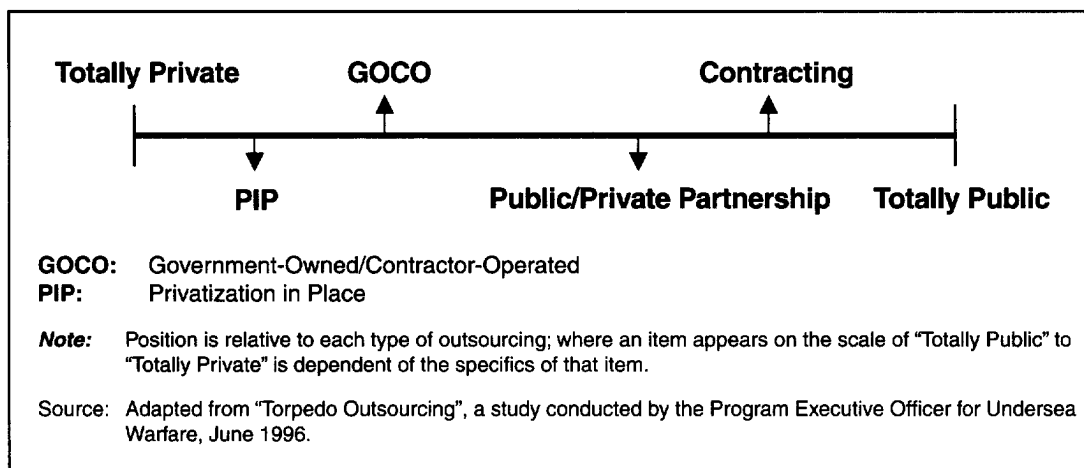
- **Air Force** – Overall, strategic sourcing seeks to balance military effectiveness (the ability to fight and win) with the incorporation, where possible, of increased efficiencies from best business practices. The selection of the optimum source and process is central to strategic sourcing and should result in improved performance, efficiency, quality, cost effectiveness, and savings for modernization, quality of life, or other Air Force priorities....<sup>12</sup>
- **Navy** – The Navy approach to reducing the total cost of providing infrastructure by conducting a comprehensive review of a business unit or units considering a wide range of options including consolidation, restructuring, privatization, make or buy decisions, adopting better management practices, development of joint venture with the private sector, asset sale, and the termination of obsolete services or programs.<sup>13</sup>

**Figure 2-2. Competitive and Strategic Sourcing Definitions**

outsourcing. The changes are not calendar-driven but rather are tied to the advances in value proposition resulting from the growth in the use of outsourcing over the past decade.<sup>14</sup>

In the infancy of outsourcing, firms were seeking fixes to specific problems. Often a company

was looking for a means to address limited resources or a desire to reduce headcount. Tactical relationships were forged to create immediate savings, eliminate the need for future investments, realize a positive cash flow from the sale of assets, or relieve the burden of staffing. When successful, the value of using outside



**Figure 2-3. The Outsourcing Spectrum**

providers was clear: better service for less investment of capital and management time.<sup>15</sup> Seeking even more value from the outsourcing relationship, the goals of these relationships expanded.

Executives realized that they were better able to direct their attention to the more critical aspects of their jobs. Outsourcing changed from being a tactical tool to becoming a strategic tool by virtue of the dollar value of the relationships, the integrated scope of services, and the length of the new relationships.<sup>16</sup> Most important, the relationships matured into long-term business partnerships. Strategic outsourcing relationships are about creating long-term value, as illustrated with the landmark Kodak-IBM information technology outsourcing deal of 1989.

In that year Kodak signed a ten-year outsourcing deal with IBM Corporation, Digital Equipment Corporation, and Businessland Inc. for \$250 million.<sup>17</sup> Kodak was not in trouble — at the time it was a “top 20 U.S. corporation” with annual revenues of \$18.4 billion.<sup>18</sup> The issue facing Katherine Hudson, then Kodak Chief Information Officer, was whether to invest \$90 million in capital expenditures on a computer center that had nothing to do with imaging. At the time many other business leaders had begun to ask the question, “what are we really in business to do?” Hudson concluded, “our mission doesn’t say ‘be the world leader in

computing’.”<sup>20</sup> Her decision to outsource was not about fixing a problem. The Kodak-IBM deal was about partnering with a provider to deliver a non-core function while focusing the firm’s resources on its vision — “...*be the World Leader in Imaging*.”<sup>21</sup> The decision to outsource was very much strategic, and the role the provider (IBM) took on was critical, or as Michael Corbett defines strategic outsourcing, “the redefinition of the corporation around its core competencies and strategic, long-term, results-oriented relationships with service providers.”<sup>22</sup> Partnership, whether between private companies or between public and private entities, is an example of strategic outsourcing, but one can take such an alliance even further.

If the first phase of outsourcing was about doing the work within existing rules, then the second phase was about using outsourcing as the corporation is being redefined. The third phase takes outsourcing a step further to transform the business — open new markets, deliver new customers, and create new products.<sup>23</sup> Outsourcing is leverage. It is paving the way to growth through partnerships. Where once firms kept outsourcing relationships hidden, firms now co-brand products and services and openly advertise their outsourcing providers. Figure 2-4 illustrates just such a relationship between the United States Postal Service (USPS) and Targeted Marketing Solutions, Incorporated (TMSI). TMSI and its advertisers pay for all costs associated with the MoversNet™ Internet

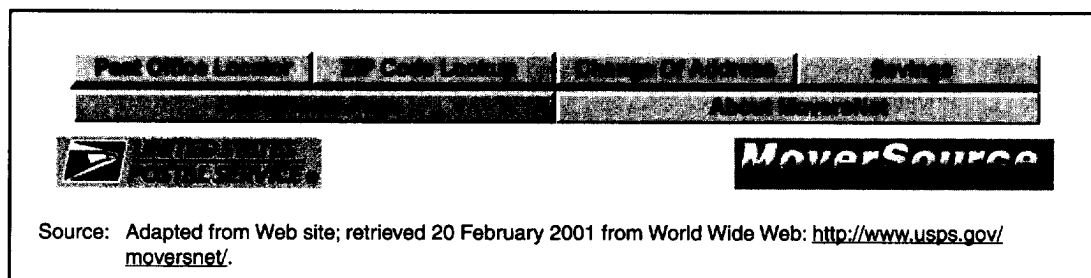


Figure 2-4. Co-Brand Illustration

Outsourcing	Strategy	Objective
	Tactical	Seeking efficiency
	Strategic	Seeking focus
	Transformation	Seeking change

Figure 2-5. Outsourcing Objectives

service and the Mover's Guide™, which are designed to offer increased help to consumers before, during, and after they relocate. This cooperative effort between the private sector and USPS reduces postal operating costs while providing products like change of address forms previously paid from USPS revenues.<sup>24</sup>

Transformation outsourcing is about actively creating interdependencies that add value to both partners in the relationship. This new transformational outsourcing recognizes that the real power of outsourcing is in the innovations that outside specialists bring to their customers' businesses. No longer are outsourcing service providers simply viewed as tools for getting more efficient or better focused; they are seen as powerful forces for change.<sup>25</sup> Outsourcing enables a firm to redefine its

theory of the business — what its business is, what its objectives are, how it defines results, who its customers are, and what the customers value and pay for.<sup>26</sup>

The decision on which outsourcing strategy to pursue is dependent on the firm's vision of where it wants to be positioned in the future (see Figure 2-5). Whether you seek efficiencies, more focus onto the core business, or whether you want to change the business altogether will dictate the strategy chosen. Hence, the Outsourcing Spectrum depicted in Figure 2-3 is inadequate since it doesn't reflect the true potential of outsourcing on the theory of the business. One should not look at outsourcing in terms of cost savings, how to do it, or who should do it, but rather in terms of "what is our vision?" Figure 2-6 reflects this

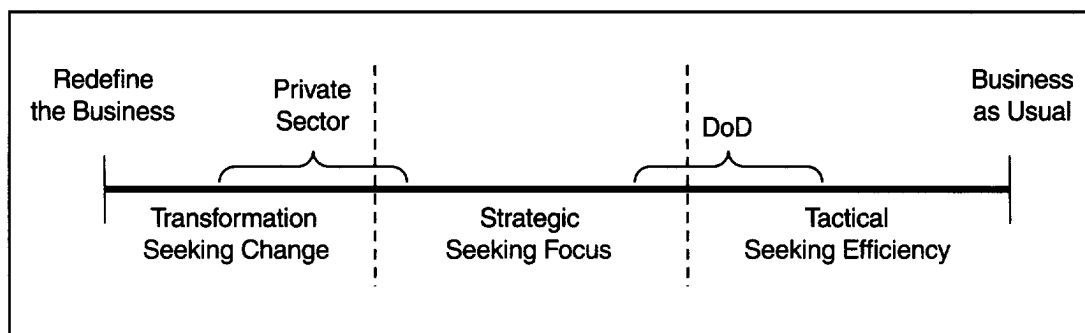


Figure 2-6. The New Outsourcing Spectrum

new spectrum and depicts where DoD and the private sector lie with respect to transforming the business. The Department is still entrenched in looking for efficiencies and focus rather than moving forward with the type of transformational vision required to make the changes dictated by emerging threats and opportunities.

That vision of where you want the business to be is captured within a corporate strategy that seizes upon the unique resources from which a corporation obtains and retains its competitive advantage. According to Peter Drucker, strategy converts the firm's theory of the business into performance.<sup>27</sup>

### What Then Is Strategy?

One can find the definition in *Webster's* (see Figure 2-7) but in the context of this treatise this definition is simply not sufficient.

We might turn to economic models, where the firm is defined by the answer to four essential questions.<sup>28</sup>

- What should the firm produce?
- How should the firm produce its output?
- Whom should the firm sell to and at what price?
- How should the firm promote its product?

To an economist, these four questions might represent the essence of strategy. However, as powerful as these questions are, they do not reflect the environment the firm operates in, the values of its management and employees, the tools at the firm's disposal, and the other players whose actions are constantly shifting the competitive landscape. In the business context we need something to motivate employees to do the right thing and manage scarce resources in today's ever changing environment. Strategy is the vital framework for overcoming conventional wisdom, reducing uncertainty, and integrating the firm toward one purpose.<sup>29</sup>

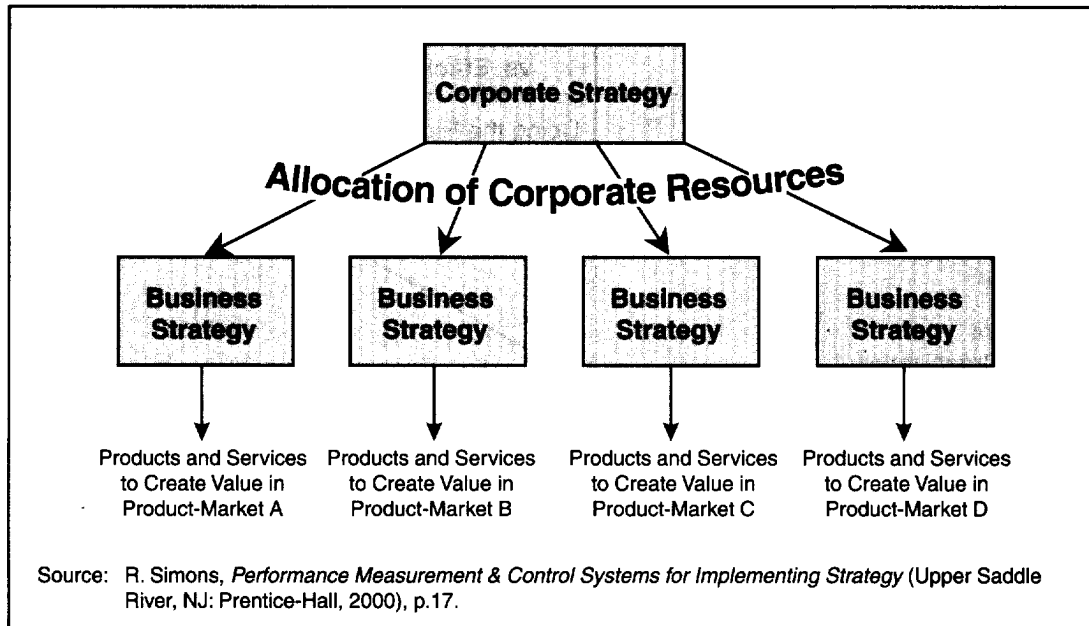
Strategy also has many different meanings depending on the context; for example, in the military, we make the distinction between national security strategy and military strategy. Within the context of this research, an important distinction is the one between business strategy and corporate strategy. Business strategy is focused on *how* a firm attains competitive advantage within an industry, or what Michael Porter termed *competitive strategy*.<sup>30</sup> Corporate strategy is concerned with *where* corporate resources are invested, seeking to maximize the value of these resources.<sup>31</sup> Just as national security strategy and military strategy are interrelated, so too are corporate strategy and business strategy, as illustrated in Figure 2-8. Business strategy is about creating value in one discernable market, whereas

#### **Strategy:**

- a) A careful plan or method: a clever stratagem
- b) The art of devising or employing plans or stratagems toward a goal

Source: Merriam-Webster's Collegiate Dictionary, retrieved 1 March 2001 from <http://www.m-w.com/cgi-bin/dictionary>.

**Figure 2-7. A Strategy Definition**



**Figure 2-8. Corporate and Business Strategy Relationship**

corporate strategy is concerned with a diversified firm. Within DoD, the Office of the Secretary of Defense (OSD) is the corporation that would set an overarching corporate strategy, and the Services and agencies within DoD are the business units that set business strategies consistent with that corporate strategy.

E. P. Learned, C. Roland Christensen, and Kenneth Andrews are quoted by David Collis and Cynthia Montgomery as stating that strategy fulfills two vital functions.<sup>32</sup> First, strategy allows a firm to position itself, *externally*, relative to its competitors within a market. In gathering a thorough understanding of this competitive environment, a firm can match its strengths and weaknesses to market threats and opportunities and formulate an effective strategy. *Five Forces Analysis*, which we describe later in this chapter, is an essential tool for this undertaking. The ultimate reward is a competitive advantage. Second, according to Porter, strategy must align *internal* activities and investments. The key is to establish consistency

among the various elements and activities and in the investment choices, thereby ensuring a process of creating competitive advantage. According to Robert Simons, the formal processes for formulating and implementing strategy is captured in a cascading hierarchy (see Figure 2-9).

The left-hand column describes the elements critical to building a successful firm. Elements flow from top to bottom in order of precedence, which is critical. Note in particular that strategy follows a firm's beliefs, vision, and mission; and structure follows strategy. Also note that while decision making flows down, systems must be in place to allow feedback to flow back up. Just as an individual listens to an internal voice when engaged in a self-evaluation, voices and signals within the organization will alert the firm as to adjustments that must be made to the elements within the organization. Clearly, the elements, or systems, must be in alignment to attain success.



garnered and accountable for any negative outcomes resulting from his or her decisions.

Strategy is the overarching plan that brings all these elements together, ensuring they operate as one system. We found the analysis of corporate strategy developed by David Collis and Cynthia Montgomery brings the discussion of strategy and the essential elements of a firm to a coherent whole.

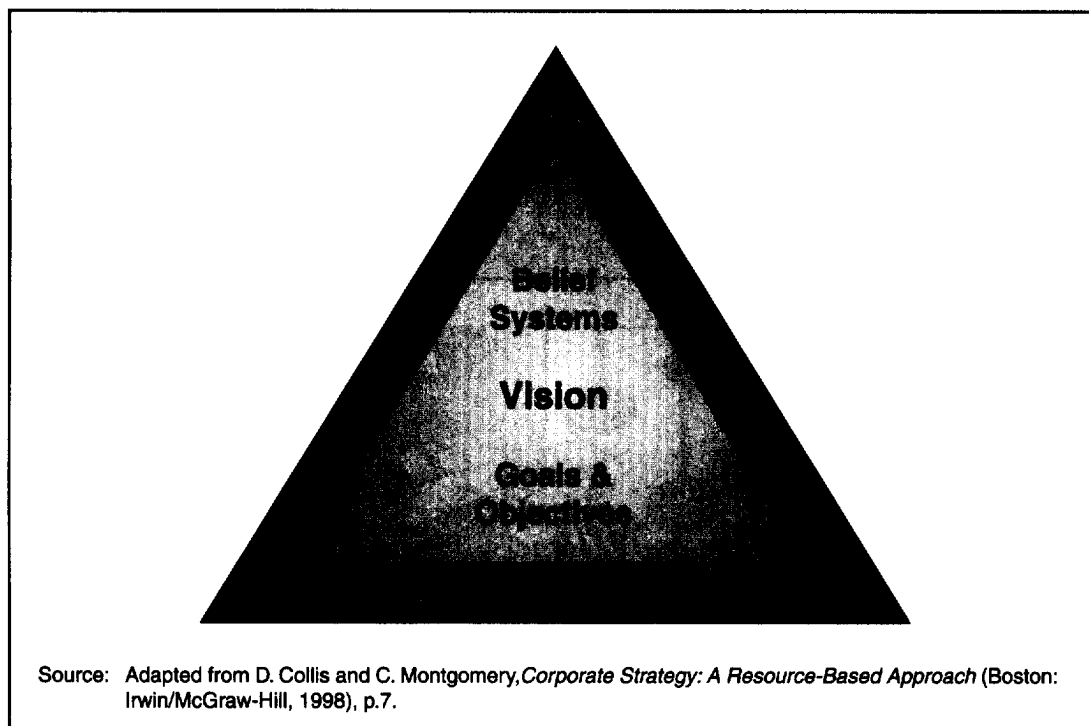
### **A Resource-Based View of Corporate Strategy<sup>33</sup>**

Corporate strategy is the way a company creates value through the configuration and coordination of its multi-market activities.<sup>34</sup> There are three essential aspects of this definition: creation, configuration, and coordination. Value creation is the ultimate purpose of a corporate strategy. The second aspect of note is the

attention to the corporate configuration, which in DoD would include the Services, agencies, geographic locations, products, etc. Finally, this framework emphasizes the need for coordination of the activities within the corporation — every activity and decision is aimed at achieving the firm's vision. Collis and Montgomery have formulated what they call the Corporate Strategy Triangle as the framework for development of effective corporate strategies (see Figure 2-10).<sup>35</sup>

The foundations of corporate strategy are the three sides of the triangle:

- Resources;
- Businesses; and
- Structure, Systems, and Processes.



**Figure 2-10. Corporate Strategy Triangle**



Firms create corporate advantage when these foundations and appropriate motivators, as set in specific goals and objectives, are aligned in pursuit of the vision.

Some might be tempted to assert that vision is paramount in this hierarchy, but after a little thought it becomes clear that in business, as in life itself, belief systems are the predominate element. Attaining business success, or anything worthwhile in life for that matter, is likely to be a difficult undertaking. Strong belief systems ensure the journey is worth taking in the first place and that the effort is worthwhile.<sup>36</sup> These systems define the organization and are the responsibility of the leadership structure to communicate and reinforce. Belief systems provide basic values, purpose, and direction for the firm.<sup>37</sup> Furthermore, if these systems are lacking or sound systems are violated, any business success becomes short term. Firms that do not have strong belief systems cannot attain a position of competitive advantage; firms that violate their belief systems can not sustain these positions.

The strength of these systems goes beyond strategy development. They serve to attract and retain professional talent. Strong belief systems

have the power to transform a job into an individual calling with rewards that go beyond monetary reimbursement. Working for organizations with strong belief systems gives people a sense of purpose. Without a strong belief system, the drive to the vision cannot be sustained.

The Johnson & Johnson Credo (see Figure 2-12) is an outstanding illustration, communicating the firm's belief system, boundaries, mission, *and* vision — those key elements from which the firm's strategy is formulated. The Credo has been guiding Johnson & Johnson since 1943, and with Johnson & Johnson's growth into the global marketplace, it is now translated into 36 languages.<sup>38</sup> Despite revisions, the Credo has not weakened. In fact, this process has reinforced and strengthened the belief systems. The Credo philosophy is what guided the difficult decisions to pull all *TYLENOL*™ products off the shelves during the crises of 1982 and 1986.<sup>39</sup> When Jim Burke, then Johnson & Johnson Chief Executive Officer, was asked about the decision he said, "I just acted in keeping with our credo and our beliefs, so I didn't even have to think about it."<sup>40</sup>

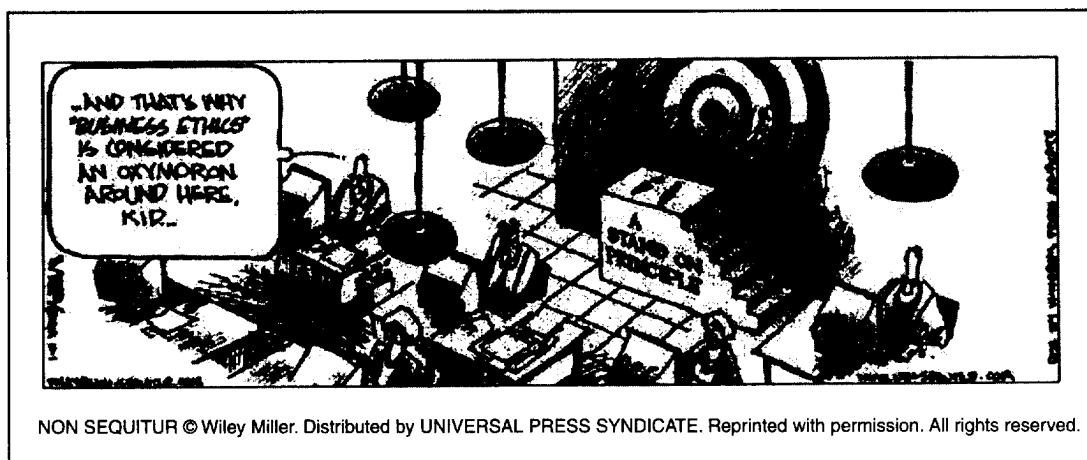


Figure 2-11. Business Ethics

## **Our Credo**

We believe our first responsibility is to the doctors, nurses and patients,  
to mothers and fathers and all others who use our products and services.  
In meeting their needs everything we do must be of high quality.  
We must constantly strive to reduce our costs in order to maintain reasonable prices.  
Customers' orders must be serviced promptly and accurately.  
Our suppliers and distributors must have an opportunity  
to make a fair profit.

We are responsible to our employees,  
the men and women who work with us throughout the world.  
Everyone must be considered as an individual.  
We must respect their dignity and recognize their merit.  
They must have a sense of security in their jobs.  
Compensation must be fair and adequate,  
and working conditions clean, orderly and safe.  
We must be mindful of ways to help our employees fulfill  
their family responsibilities.  
Employees must feel free to make suggestions and complaints.  
There must be equal opportunity for employment, development  
and advancement for those qualified.  
We must provide competent management,  
and their actions must be just and ethical.

We are responsible to the communities in which we live and work  
and to the world community as well.  
We must be good citizens — support good works and charities  
and bear our fair share of taxes.  
We must encourage civic improvements and better health and education.  
We must maintain in good order  
the property we are privileged to use,  
protecting the environment and natural resources.

Our final responsibility is to our stockholders.  
Business must make a sound profit.  
We must experiment with new ideas.  
Research must be carried on, innovative programs developed  
and mistakes paid for.  
New equipment must be purchased, new facilities provided  
and new products launched.  
Reserves must be created to provide for adverse times.  
When we operate according to these principles,  
the stockholders should realize a fair return.

Source: Reproduced with permission. All rights reserved. Retrieved 8 March 2001 from World Wide Web:  
[http://www.johnson-n-johnson.com/who\\_is\\_jnj/cr\\_usa.html](http://www.johnson-n-johnson.com/who_is_jnj/cr_usa.html).

**Figure 2-12. Johnson & Johnson Credo**

If strategy is the means of getting to the end point, the firm's vision is the beacon. The business community has adopted vision statements as a means of stating direction and purpose. To be effective, a vision must have some critical characteristics. John Kotter summed these characteristics as follows.<sup>41</sup>

- The vision must be imaginable, conveying a picture of what the future will look like.
- The vision must be desirable, appealing to the long-term interests of employees, customers, stockholders, and others who have a stake in the enterprise.
- The vision must be feasible, composed of realistic and attainable goals.
- The vision must be focused, providing guidance in decision-making.
- The vision must be flexible, allowing individual initiatives and alternative responses in light of changing conditions.
- Finally, the vision must be communicable — easy to communicate.

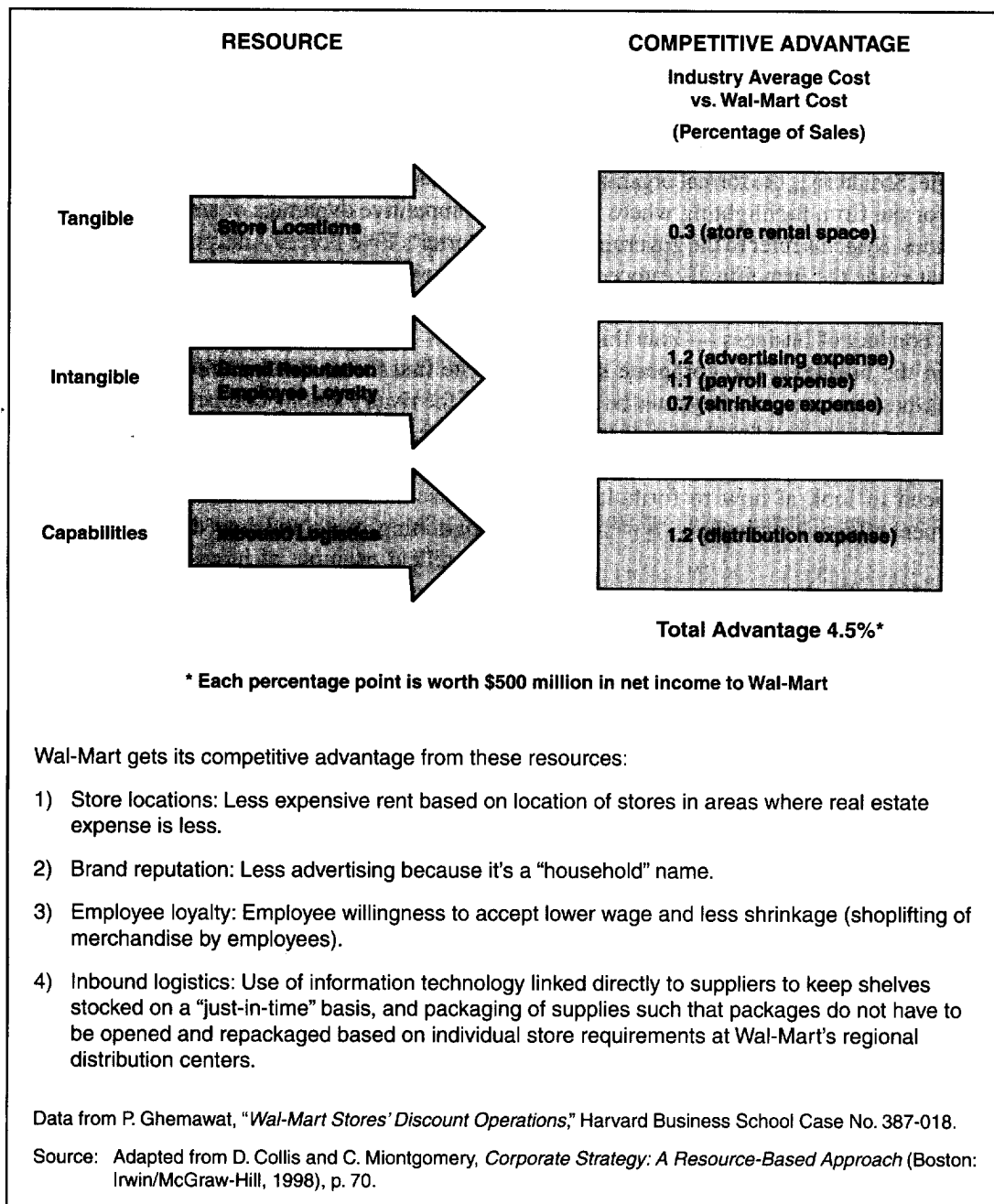
A good test of this last element is if the vision can be clearly and consistently explained in a short amount of time. Kotter cites five minutes as a benchmark. A clear illustration is the Kodak vision cited earlier, "...*Be the World Leader in Imaging*." The vision sets the strategic boundaries of what businesses the firm will do and not do. For Kodak that boundary is imaging.

The vision is the long-term objective, or as in the Kodak example, no reference is even made to a time frame for achieving the vision. Therefore short-term goals and objectives are needed to motivate behavior within the firm — establish achievable and visible targets. Performance

measurement and control systems are aligned with these goals and objectives to properly motivate and reward employee behavior. These goals and objectives are the stepping stones toward achieving the vision and competitive advantage.

Competitive advantage is based on a firm's unique set of resources and how those resources are used.<sup>42</sup> A firm's resources fall into three categories: tangible, intangible, and organizational capabilities. Tangible assets are items like production facilities or warehouses, i.e., items you can touch and see. On the other hand, intangible assets include brand names, trademarks, know-how, and reputation. Organizational capabilities are really a complex combination of assets, people, and processes that are used by a firm to convert input into output, typically with better efficiency and quality than a firm's competitors. Wal-Mart, overall number three on the Fortune America's Most Admired Companies list, illustrates all three types of resources (see Figure 2-13).<sup>43</sup> These resources that give a firm competitive advantage are hard to imitate. According to Collis and Montgomery, resources determine what a firm *can do*, not what it *wants to do*.

What a firm can do is reflected on the "business" side of the triangle. Obviously, the business strategy within each business must align with the overall corporate strategy. The key is to operate in businesses that allow a firm to share resources, capturing economies of scale and scope. Economies of scale exist when average cost declines as a good or service is produced or sold in larger volume.<sup>44</sup> To those of us in the military, economies of scale equate to average cost-per-unit of a weapon system, which typically decreases as the production run increases. Economies of scope exist when the cost of producing or selling multiple products together is lower than the cost of producing and selling the same quantity of



**Figure 2-13. Wal-Mart from a Resource-Based View**

goods individually.<sup>45</sup> Again, in the defense industry, this relates to the drive for commonality in systems, which, when used to advantage, can lower the cost for each weapon.

Identifying scale and scope effects requires data-driven analyses and a systematic process called *Value Chain Analysis*, which we will describe later in this chapter.

Exploiting scale and scope economies requires profound changes in organizational structure and systems because they depend on the sharing of resources and coordination, which brings us to the third side of the Corporate Strategy Triangle. Structure is the formal organizational chart for the firm, highlighting where authority resides. Systems refer to the governing policies that guide the firm. Finally, processes are the informal relationships involved in the day-to-day conduct of business — how things get done in the business. The corporate strategy dictates these features, and they must be aligned with the resources and businesses of the firm. With a common understanding of strategy, we now need to look at how to formulate and implement effective strategies.

### Tools of the Trade

There are several analytical tools important to our analysis of DoD from a business perspective. These tools are:

- Five Forces Analysis;
- Value Chain Analysis;
- The Value Net;
- Levers of Control; and
- Game Theory.

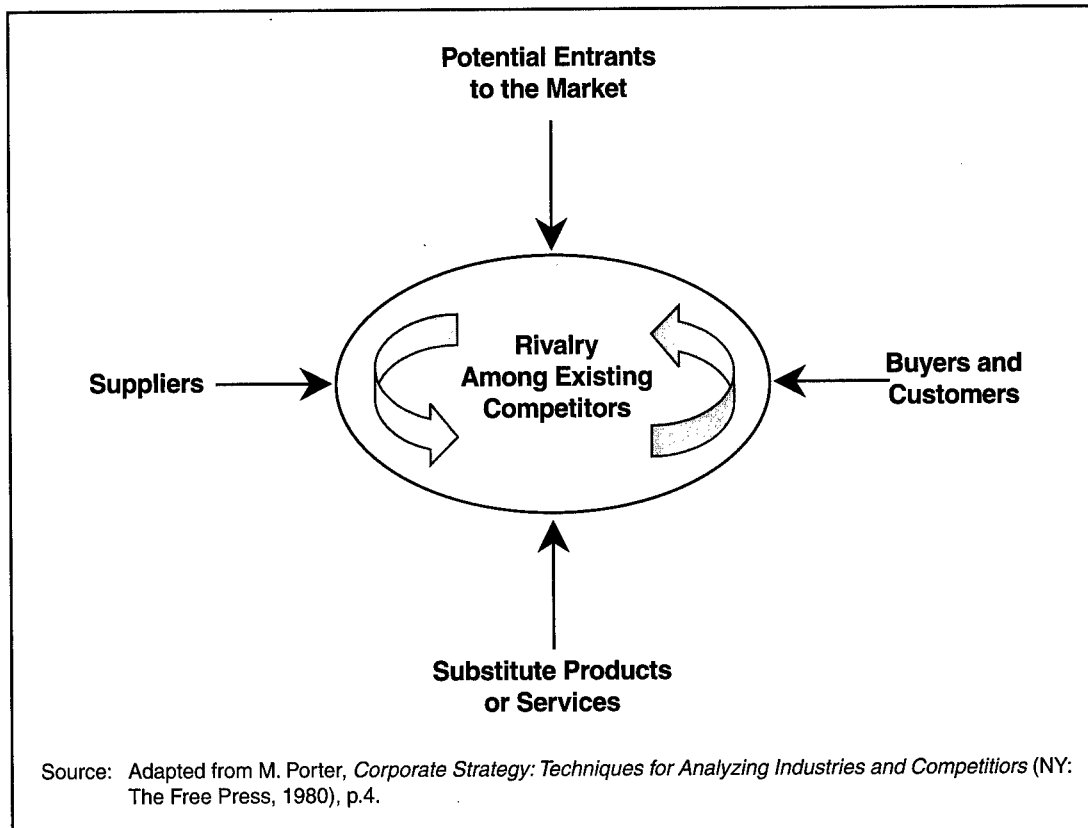
The first three are essential to formulating an effective strategy, while the fourth guides the implementation of the strategy. Finally, as a firm monitors the horizon for emerging opportunities and threats, Game Theory is an important tool for analyzing the strategic behavior of all the players and potential players in an industry.

### Five Forces Analysis

As mentioned above, strategy allows a firm to position itself appropriately within an industry relative to its competitors. Figure 2-14 depicts the leading tool in use today for analyzing the competitive dynamics of an industry, Michael Porter's Five Forces Analysis. The framework relates the profitability of the firms in an industry to five competitive forces.<sup>46</sup>

The first force, *Rivalry*, looks at the intensity of the rivalry among competitors and its effect on the value that can be drawn from the industry. There are numerous factors that can increase the intensity of the rivalry, such as low switching costs and low differentiation. An excellent example of intense rivalry is found in the soft drink war between Coca-Cola® and Pepsi-Cola®. Switching costs are clearly low — it's as easy to put a dollar in the Coke® drink dispenser as the Pepsi® one. After all, despite all the taste tests, to most people a cola is a cola — there is little product differentiation. There are numerous other factors that affect the degree of rivalry; suffice it to say that this is one of several forces that together define the competitiveness of an industry.

Focusing on the horizontal axis, we will describe forces that determine where the value created in an industry is appropriated. In looking at *Suppliers*, one assesses the bargaining power of the firm's suppliers and that of the buyer or customer within the particular market. In the mid-1980s, the sweetener industry had one well-known product, NutraSweet™.<sup>47</sup> Searle by virtue of its patent for NutraSweet held the bargaining power. With the public's concern over the safety of artificial sweeteners, Searle quickly capitalized on the U.S. Food and Drug Administration's approval of NutraSweet by implementing a strategy to make NutraSweet the brand name associated with aspartame. The sweetener rapidly became



**Figure 2-14. Five Forces Analysis**

a household name. With the patent and the brand name in hand, Searle was able to charge the beverage industry \$70 per pound for NutraSweet. In 1985 Monsanto acquired Searle and the ownership of NutraSweet. As the only supplier in the game, Searle and later Monsanto had tremendous bargaining power over Coke and Pepsi. In fact, you might recall the quite visible NutraSweet symbol on a Diet Coke or Diet Pepsi can.

On the other side of this axis is the force, *Buyers and Customers*. Continuing the illustration, in 1987 Monsanto's European patent expired, pulling down the entry barrier for a new sweetener entrant, Holland Sweetener Company (HSC). With HSC's entry, the European price for aspartame fell to \$22-\$30 per pound as the

rivals, Monsanto and HSC, engaged in a price war. Suddenly, the volume buyers of sweetener in Europe, including Coke and Pepsi, were the benefactors of this price reduction. In 1992, Monsanto's U.S. patent also expired, and the price war quickly escalated into the U.S. However, the past efforts to brand NutraSweet left little desire by Coke or Pepsi to use a generic aspartame, especially given the debacle of New Coke in 1985. Neither Coke nor Pepsi wanted the consumer to think they were tampering with the recipe. So Coke and Pepsi signed new long-term contracts with Monsanto. Predictably, Coke and Pepsi captured combined savings of \$200 million annually because of their increased bargaining power with two suppliers now in the game.<sup>48</sup>

On the vertical axis, one examines the industry from the perspective of the final two forces, the threat of new entrants and substitutes. The key concept in analyzing new entrants is the concept of entry barriers.<sup>49</sup> Barriers exist when it is difficult or economically challenging for a new entrant to compete at the same level of the incumbent(s). Continuing our cola war, new entrants into the soft drink industry have found it difficult to displace Coke or Pepsi because these two rivals have well-established brand names. The new entrant is unlikely to have the resources to mount the market campaign required.

However, a beverage company that has attempted to market a brand strongly is Snapple®. Snapple is an example of a substitute product that entered the market in 1972 with a differentiated offering.<sup>50</sup> Unlike most Coke and Pepsi products, Snapple teas and fruit-flavored drinks are made of natural ingredients. Snapple

entered the market banking on the soft drink industry's low switching costs. However, through the strength of their existing product line and new product offerings, Coke and Pepsi's combined market share of the U.S. soft drink industry has remained steady at between 74 and 75 percent over the last five years.<sup>51</sup> Coke and Pepsi have withstood the onslaught of new entrants and substitutes like Snapple.

In conducting a Five Forces Analysis, two factors stand out as a common theme among the forces: cost and differentiation. In fact these are two of the three generic strategies that Michael Porter describes as viable choices for dealing with the competitive forces within an industry: overall *Cost Leadership* and *Differentiation*.<sup>52</sup> Porter goes on to introduce the "value chain" template. The importance of the value chain is its ability to disaggregate a firm into the key activities that determine competitive advantage.

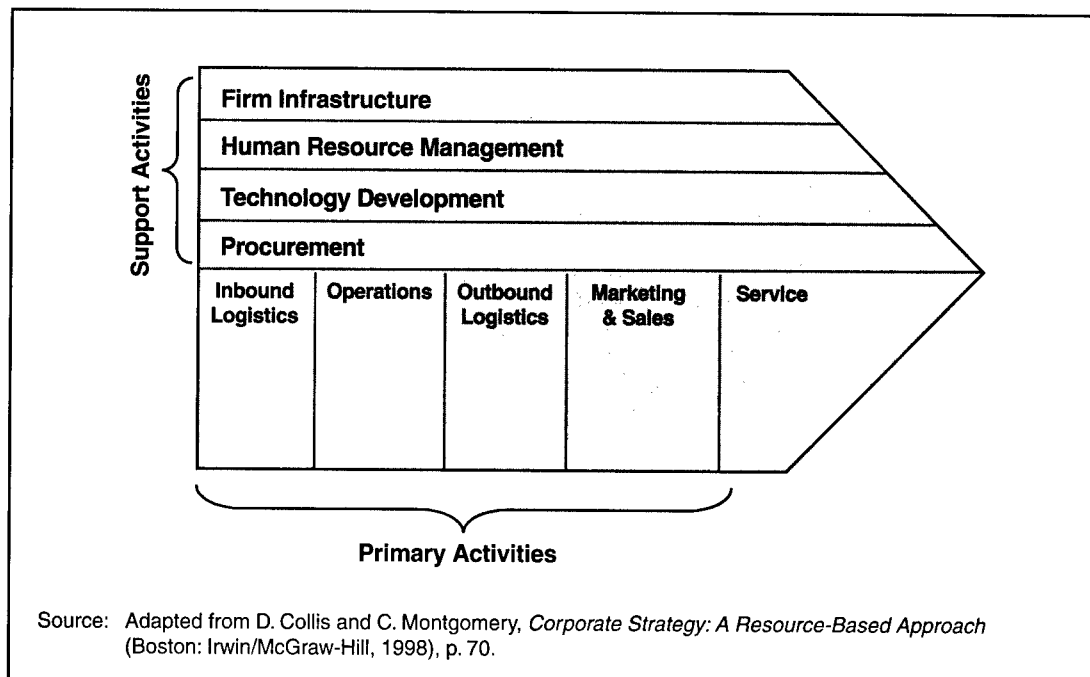


Figure 2-15. Generic Value Chain

## Value Chain Analysis

A firm's value chain is a collection of activities performed by the firm to design, produce, market, deliver, and support a product.<sup>53</sup> In laying out a generic value chain, Porter distinguishes between a firm's support-type activities and primary-type activities as shown in Figure 2-15. Under each of these activity types,

any number of activities can be broken out, depending on the level of analysis sought. In conducting an analysis of a firm's strategy, the activities must be disaggregated such that the scale and scope drivers of cost and differentiation can be identified within each activity.<sup>54</sup> For further understanding, one should refer to Figure 2-16, Thermostat Value Chain Analysis.

Take for example a firm that currently manufactures only industrial thermostats, but forecasts little growth opportunities in industrial thermostats. Yet, it does see potential growth in the consumer household market, and is considering expanding into that market. Although an expansion from industrial thermostats to household thermostats seems logical on the surface, the resources that are required to support both businesses are quite different. When we look at the support and primary activities involved in developing, manufacturing, selling, and supporting a thermostat, we see in italics that the resources required for a home thermostat are quite different from those of an industrial one.

- In the Technology Development support activity, an industrial thermostat requires customized research and development (R&D) designed for each unique application, whereas a consumer thermostat would be designed with attractiveness and user-friendly features as key emphases. The firm had significant R&D resources, but no experience in product packaging and appearance so important to the consumer.
- In the primary activity of Production Operations, an industrial thermostat is built per a specification unique to application, while a consumer thermostat lends itself to automation and mass production. Clearly, this expansion would not capture any economies of scale since the average production cost is not likely to decrease because you can't mass produce the industrial thermostat. In fact, cost may increase to operate separate production lines or to reconfigure the line for each application.
- In the primary activities of Outbound Logistics and Marketing & Sales, an industrial thermostat is directly sold and installed by the engineers, whereas the consumer thermostat is sold through distributors, requiring extensive advertising and sales representatives to garner support from the distributors. Here, economies of scope are unlikely to lower costs since you have to add new skills to produce and sell the consumer thermostat.
- Finally, when it comes to Service, the industrial thermostat has an extensive customer support and repair program to differentiate the product. On the other hand, the consumer version need not require any service program.

Thus the firm has little opportunity for scale or scope economies, and should not expand into household thermostats. Clearly, industrial and commercial thermostats are distinct business units, requiring distinctly different resources to garner competitive advantage and capture value.

(continued)

Source: Adapted from D. Collis and C. Montgomery, *Corporate Strategy: A Resource-Based Approach* (Boston: Irwin/McGraw-Hill, 1998), p. 70.

**Figure 2-16. Thermostat Value Chain Analysis<sup>55</sup>**



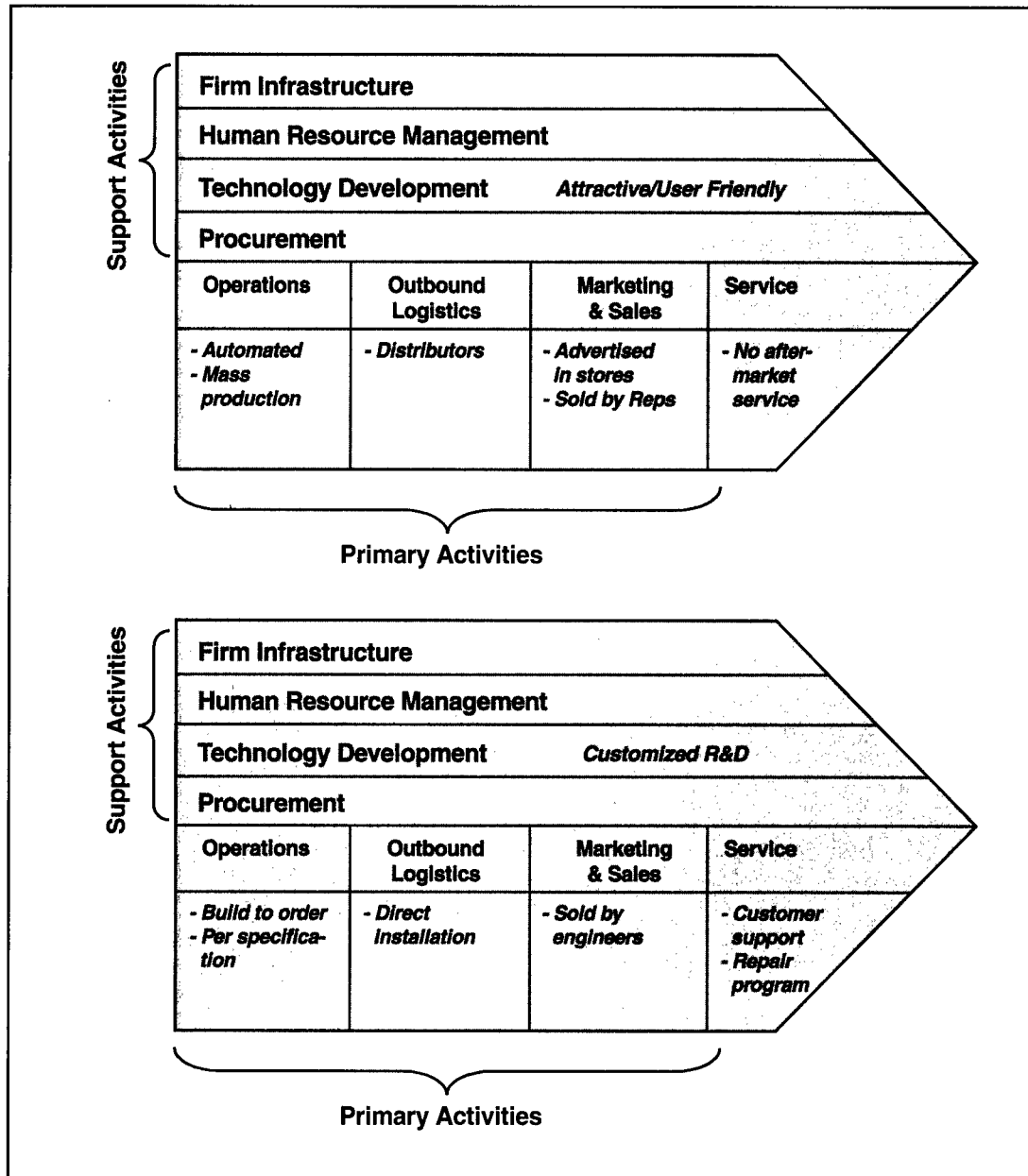


Figure 2-16. Thermostat Value Chain Analysis (continued)

Now one understands how Five Forces Analysis and Value Chain Analysis define the competitive landscape in which a firm finds itself. However, as discussed earlier, business isn't necessarily only about competition, it's also about creating value. As we show in the

previously mentioned USPS co-branding example, firms can be cooperative, thereby expanding the value of a product or service. Fortunately we have another tool that fosters an understanding of the cooperative landscape.

## The Value Net

An expansion of the Five Forces Analysis that addresses cooperation among firms is *The Value Net* (see Figure 2-17). The significance of the Value Net is that it introduces the concept of complementors. A firm is your complementor if the customer values your product more when they have the other firm's product or service than when he has your product alone.<sup>56</sup> In the personal computer world, Microsoft® and Intel® are complementors. The value of the Windows™ operating system is driven by the computing power of the chip, and the value of the Intel Pentium™ microprocessor is driven by the increased versatility of the software it hosts. The relationship is so powerful to have received the moniker, "Wintel." Since Microsoft and Intel are not competitors, neither firm would come up on one another's radar screen when conducting a Five Forces Analysis. The Value Net

tool helps identify all the players in the market, including collaborators; and more importantly, the effect these collaborators have on value creation and who acquires that value.

## Levers of Control

Once a firm formulates what it believes to be an effective strategy, the firm must ensure the strategy is implemented correctly in order to create value. The more effective the strategy, the more likely the company will attain its objective. The strategy must not only be effective but also subject to constant review and revision — it is an iterative process. Monitoring and controlling strategy during implementation is achieved through the use of four levers as shown in Table 2-1. Beliefs and Boundary Systems were discussed above. The other two levers warrant further description.

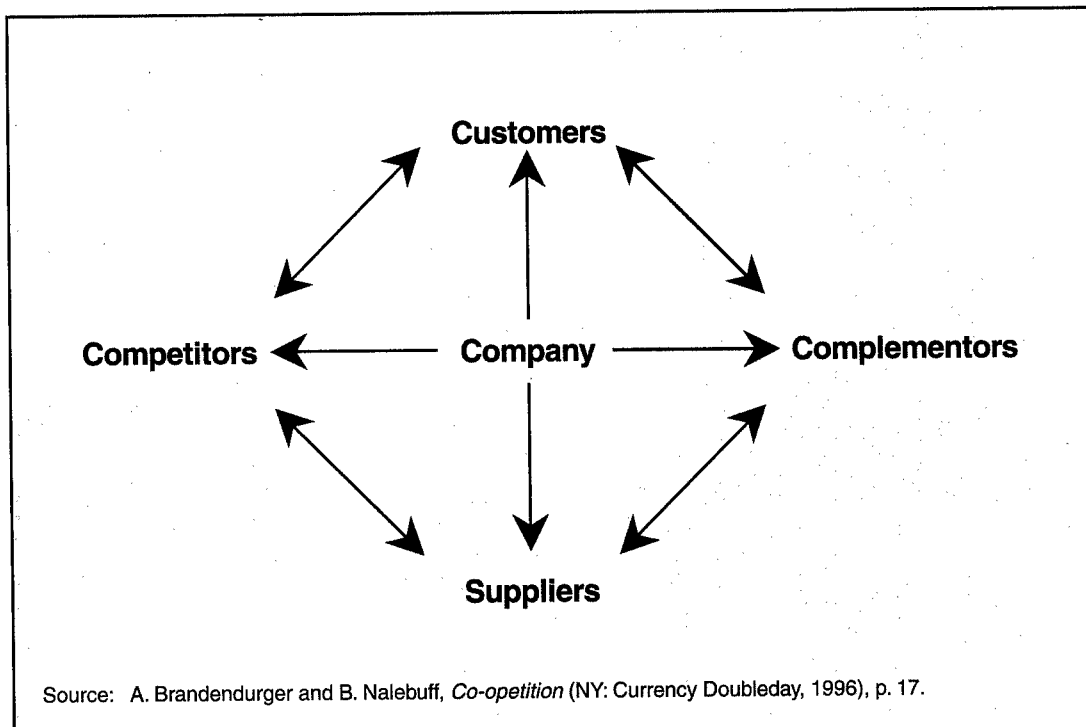


Figure 2-17. Value Net

Control System	Purpose	Communicates	Control of Strategy as
<b>Belief Systems</b>	Empower and expand search activity	Vision	Perspective
<b>Boundary Systems</b>	Provide limits of freedom	Strategic domain	Competitive Position
<b>Diagnostic Control Systems</b>	Coordinate and monitor the implementation of intended strategies	Plans and goals	Plan
<b>Interactive Control Systems</b>	Stimulate and guide emergent strategies	Strategic uncertainties	Pattern of actions

**Table 2-1. Relationship of Four Levers of Control to Strategy**

*Diagnostic Control Systems* are the formal information systems that managers use to monitor organizational outcomes and correct deviations from preset standards of performance.<sup>57</sup> Balanced scorecard, project monitoring systems, and cost-accounting systems are examples that can be used diagnostically. One might be tempted to ask, “How can cost-accounting systems that are traditionally built on financial reporting be used as a diagnostic indicator?” In order to do so, Robert Simons emphasizes that these systems must be capable of:

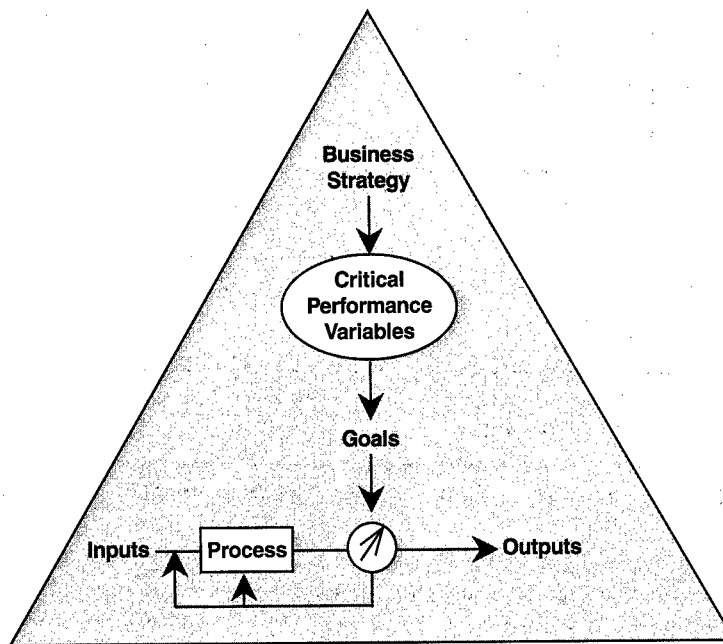
- Advance goal-setting;
- Measuring output;
- Calculating variances; and
- Using the variance information for changing inputs and/or processes appropriately.<sup>58</sup>

As depicted in Figure 2-18, the diagnostic control system chosen must link the strategy to intermediate goals. That link is a set of critical performance measures that must be achieved for the intended strategy to succeed.<sup>59</sup> Done correctly, the firm can operate on “autopilot,”

allowing management to focus only when a red flag arises. The Return on Management (ROM) is increased because less management time and attention are invested in needless micromanaging.

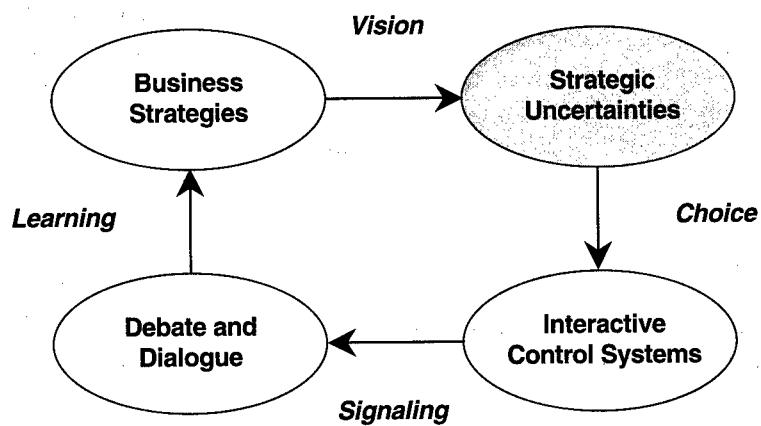
Freeing management’s time is essential so that senior leadership can direct their energies toward growth and innovation. Businesses, like the military, must monitor the horizon for new threats and opportunities that can render the current strategy useless. (Later in this chapter, we will overview Game Theory, which is a useful set of tools a firm can use to adjust its strategy appropriate to a competitor’s likely actions.) Simons calls these threats and opportunities *strategic uncertainties*. Understanding the impact of these uncertainties on the firm’s business is about learning to adapt and change. Diagnostic control systems and critical performance variables aren’t conducive to learning. *Interactive Control Systems* are as shown in Figure 2-19.

The distinction between critical performance variables and strategic uncertainties is an important one to understand. The former is about staying on track while the latter is about



Source: Adapted from R. Simons, *Performance Measurement & Control Systems for Implementing Strategy* (Upper Saddle River, NJ: Prentice-Hall, 2000), p. 210.

**Figure 2-18. Link from Strategy to Diagnostic Control Systems**



Source: Adapted from R. Simons, *Performance Measurement & Control Systems for Implementing Strategy* (Upper Saddle River, NJ: Prentice-Hall, 2000), p. 217.

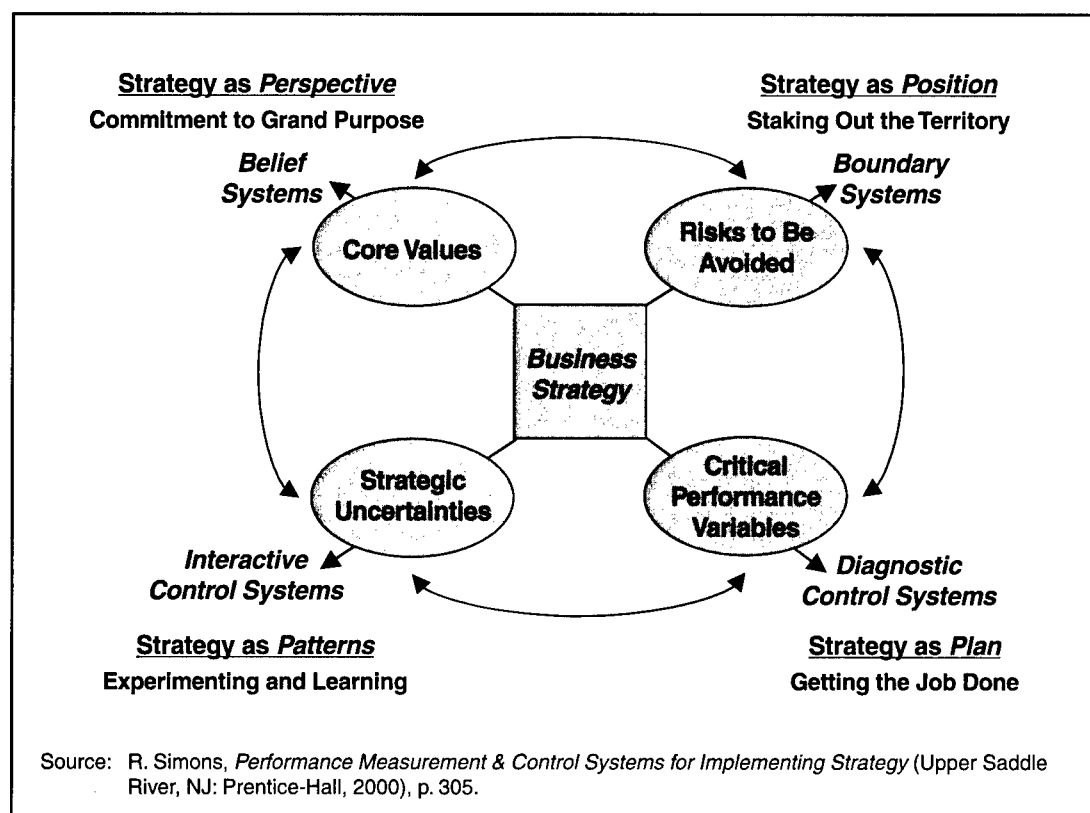
**Figure 2-19. Interactive Control Systems Drives Learning**

	Critical Performance Variables	Strategic Uncertainties
<b>Recurring Questions</b>	What must we do well to achieve our intended strategy?	What changes in assumptions could alter the way we achieve our vision for the future?
<b>Focus On</b>	Implementing strategy	Identifying and testing new strategies
<b>Driven By</b>	Goal achievement	Top management unease and focus
<b>Search For</b>	Effectiveness and efficiency	Disruptive change
Source: Adapted from R. Simons, <i>Performance Measurement &amp; Control Systems for Implementing Strategy</i> (Upper Saddle River, NJ: Prentice-Hall, 2000), p. 216.		

**Table 2-2.**  
**Distinction between Critical Performance Variables and Strategic Uncertainties**

questioning whether we are still on the right track. Table 2-2 summarizes the differences in the two.

Interactive Control Systems are not necessarily unique systems. Balanced scorecard and project monitoring systems can be interactive



**Figure 2-20. Levers of Control**

just as they can be diagnostic. However, the criteria for an interactive system are different. An interactive control system must have the following criteria:

- Contains simple to understand information, like market share;
- Provides information about strategic uncertainties, such as technology advances;
- Is accessible to managers at multiple levels;
- Generates new action plans.<sup>60</sup>

The bottom line is that an interactive control system focuses management attention on the key issues affecting the firm's ability to capture value.

The four levers are not operated upon independently. The *Levers of Control* model (Figure 2-20) depicts the interrelations of these levers

and how they orchestrate a firm's behavior and actions in implementing the firm's strategy.

Moving clockwise, Belief Systems set the values and norms of the firm, while Boundary Systems establish the firm's strategic boundary based on those values and norms. In addition, Boundary Systems determine where decision rights reside within the firm. Diagnostic Control Systems establish the proper metrics, incentives, and rewards that enable the firm to operate at faster pace to meet challenges of strategic uncertainty. Interactive Control Systems allow the firm to monitor the strategic horizon and adapt quickly through learning. Table 2-3 illustrates the likely outcomes of operating the levers independently or without any one of them.

Again, operated as one overarching system, the Levers of Control allow us to deal with strategic uncertainty, which is a critical parameter to understand in the day-to-day business

Belief Systems (Values, Norms)	Boundary Systems (Decision Rights)	Diagnostic Control Systems (Metrics, Rewards)	Interactive Control Systems (Knowledge Flows)	Outcomes
No	Yes	Yes	Yes	<ul style="list-style-type: none"> <li>– Misconduct</li> <li>– Low Inspiration</li> <li>– Poor Teamwork</li> </ul>
Yes	No	Yes	Yes	<ul style="list-style-type: none"> <li>– Uncertainty</li> <li>– Power Struggles</li> <li>– Indecision</li> <li>– Inconsistency</li> </ul>
Yes	Yes	No	Yes	<ul style="list-style-type: none"> <li>– Low Motivation</li> <li>– Passive, Slow Pace</li> <li>– Unclear Purpose</li> </ul>
Yes	Yes	Yes	No	<ul style="list-style-type: none"> <li>– Poor Decisions</li> <li>– Strategic Surprises</li> <li>– Poor Coordination</li> <li>– Low Learning</li> </ul>
Source: Adapted from summary class notes, T. Piper, <i>Achieving Profit Goals &amp; Strategies</i> , Corporate Financial Management, Program for Management Development (PMD75), Harvard Business School.				

**Table 2-3. Organizational Outcomes**

operation. We next turn our discussion to Game Theory — a tool that helps us understand some of this uncertainty, namely what decisions might our firm and the other players make.

## Game Theory

Since we have identified the key players, the tools for formulating an effective strategy, and the levers for controlling strategy implementation, we are now ready to play the game. We refer to it as a game; however, it is a serious and complex game, requiring the utmost knowledge, skill, and preparation. In any game there are *players*, who are the decision makers; there are *strategies*, which are the choices that a player makes; there are *actions*, which are based on each player's strategy; and there are *outcomes*.<sup>61</sup> Game Theory is a set of tools for

analyzing the decision making in a game where understanding the strategic behavior of players is critical.

We use a game tree, which is an extension of a decision tree, to help illustrate the game dynamics. We can now show a game tree for our situation in the Prisoner's Dilemma, Figure 2-21).

The players are Prisoner A and Prisoner B, who each have a dominant strategy, which is the self-protecting, risk-averse strategy similar to DoD and its traditional relationship with private industry. Their actions are either to confess or to keep quiet. Their prison sentences are the outcomes. Playing this pair of strategies leads to an outcome in which both sides are worse off than they would be if they cooperated and

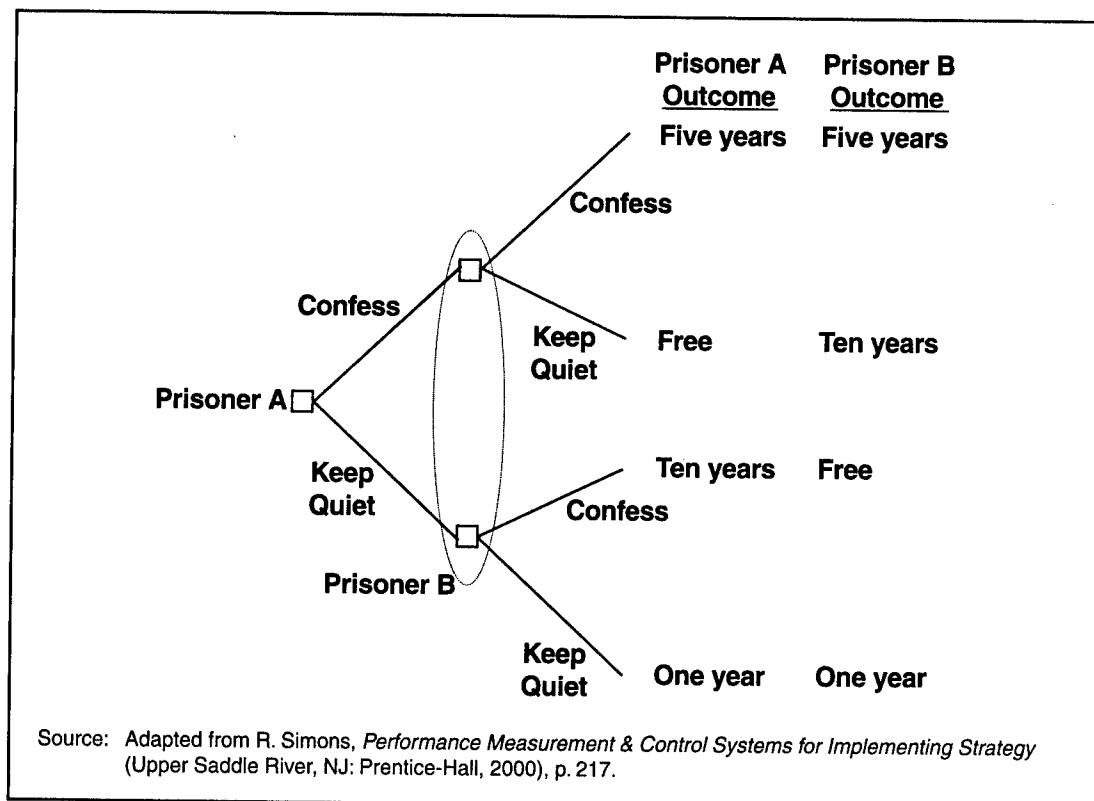
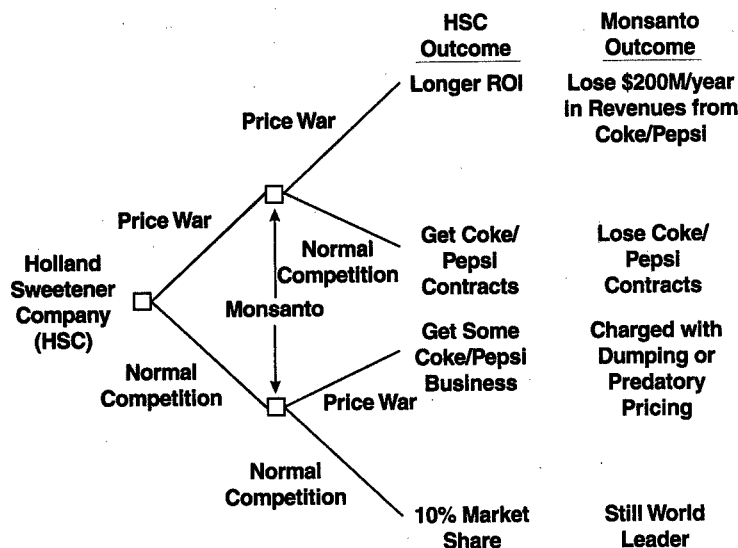


Figure 2-21. Prisoner's Dilemma Game Tree

We can return to the sweetener story to illustrate the application of Game Theory in the business world. Both the Holland Sweetener Company (HSC) and Monsanto had two strategies they could each pursue: a price war or normal competition. If HSC chose normal competition, then Monsanto could either respond by competing normally or cutting their prices in order to drive HSC out of the business. The possible outcomes are shown for each scenario. The best choice is for both to engage in normal competition. At this time (mid-1980s to early-1990s), the diet soft drink market was growing significantly (diet soft drink was estimated to reach 50 percent of the U.S. soft drink market by 1995).<sup>62</sup> Monsanto could not meet the worldwide demand on its own, so there was room for a second player, especially one only interested in capturing enough value to be profitable. Thus, HSC might capture 10 percent of the market, while Monsanto would remain the industry leader. On the other hand, if Monsanto chose to wage a price war, they risked losing some if not all of the Coca-Cola and Pepsi-Cola contracts to HSC, and they would likely be challenged by HSC for dumping or predatory pricing. Dumping is putting a product into a market at a lower price than your home market. Predatory pricing is selling below variable cost; i.e., you are selling at a loss. It also turns out that NutraSweet was Monsanto's only division turning a profit.

If HSC were to choose to engage in a price war, Monsanto again could either respond by competing normally or cutting their prices in order to drive HSC out of the business. If Monsanto chose to ignore HSC's price-cutting, Monsanto would likely lose some if not all of the Coke and Pepsi contracts. As it turns out, HSC did engage in a price war and Monsanto reciprocated likewise. As a result, HSC nearly went under, but hung on since Coke and Pepsi were motivated to keep a second supplier in the game.<sup>63</sup> In fact, HSC did expand their capacity. With Coke and Pepsi signing contracts with HSC, Monsanto lost \$200 million in annual revenues.

Clearly, both HSC and Monsanto should have employed the normal competition strategy in order to capture more value from the growing diet soft drink market.



Source: Adapted from class notes, S. Bradley, *Competition and Strategy*, Program for Management Development (PMD75), Harvard Business School.

Figure 2-22. Bitter Competition



played alternative strategies. Imperfect information or a lack of information causes the dilemma, which is indicated by the dashed oval around Prisoner B's two decision nodes. Prisoner B does not know what decision Prisoner A has made: did he confess or did he keep quiet? If neither confesses, they will be convicted of a lesser crime that is easily proven giving each a one-year sentence as shown in the bottom outcome. If one confesses and the other stays quiet, the confessing prisoner will go free and the one who stayed quiet will receive a ten-year sentence as shown in the two middle outcomes. If both confess, each prisoner will receive a five-year sentence as shown in the top outcome. Clearly, both prisoners are collectively better off if they stay quiet, but lacking information on what the other did, each is likely to make the wrong decision and confess to avoid ten years of imprisonment. For a

further illustration of Game Theory refer to Figure 2-22, Bitter Competition.

### **Summary**

In this chapter, we have provided a definition of outsourcing, but more important we have shown the dramatic impact that outsourcing has had in the private sector in terms of reshaping the theory of the business. We have also defined the essential tools for defining a theory of the business. These tools help shape the firm's behavior, dictate its decisions about what to do, and define what the firm considers meaningful results. In the next chapter, we will examine more closely the ways in which the private sector formulates business strategy and the resulting outsourcing decisions that have been driven by that choice of strategy.

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# 3

## BUSINESS APPROACHES TO STRATEGY, INTEGRATION, AND OUTSOURCING

*“One can be Captain of his ship but  
one can never be Captain of the Ocean.”*

— Anonymous

### Introduction

In Chapter Two we described various models used to devise strategy. This included an overview of the enabling elements of strategy, such as belief systems, vision, and mission. In this chapter we use these models and elements to describe how business strategies are formulated in the commercial world and how integration and outsourcing decisions are made in light of these decisions. Later we will apply these same principles to the Department of Defense (DoD). For now however, it is important to show that business structure, including the size and scope of the firm, is driven by business strategy.

As has been stated, firms seek to gain a competitive advantage. Decisions on which activities to do internally and which to outsource are made in light of strategic objectives.<sup>1</sup> While DoD — through the process set forth in the Office of Management and Budget (OMB) Circular A-76 (A-76) — emphasizes cost when

making these decisions, business management literature emphasizes that lower costs should not be the primary or the only goal of outsourcing. Michael Corbett [1995] lists the following goals in descending order of importance:<sup>2</sup>

1. Improving Business Focus;
2. Gaining Access to Superior Capabilities;
3. Accelerating Re-Engineering Efforts to Reduce Cycle Times and Improve Quality;
4. Sharing Risks;
5. Reducing Operating Costs;
6. Converting Capital Investments in Non-Core Functions into Operating Expense;
7. Gaining Better Control Over Functions That Are Not Meeting Performance Goals or Customer Expectations.

Note that reducing cost is listed fifth. While this may come as a surprise to many (especially to those of us in DoD), there are some compelling reasons why successful, responsive, and highly profitable companies do not make integration and outsourcing decisions solely on the basis of cost.

We begin by exploring why this is so. This starts with an examination of the economic forces that limit the optimal size of the firm and necessitate outsourcing. From there, the discussion goes beyond economics and resources to elements of strategy covered in the previous chapter. For successful businesses, structure is driven by strategy, not by financial plans. Outsourcing and integration decisions go beyond economic models and cost comparisons. Such decisions do not lie within the realm of bean counters and bookkeepers.

All firms outsource. The key is to understand how to do it in such a way as to yield the greatest strategic advantage to the firm.

### **Limits to the Size of the Firm**

We have made the point that effectiveness must take precedence over efficiency. Accepting this, one might be tempted to think that the greater the degree of control, the greater the degree of effectiveness one can exercise. If the overarching goal is to be effective, why outsource at all? The answer is that there are limits to what any organization can effectively do. Strategy requires focus and focus requires that some activities be performed outside the firm. In this section, we will examine what constrains the size of the firm and what factors cause diminished effectiveness as size increases.

The firm's resources are of course finite. Strategy, in its essence, is a series of carefully crafted premeditated decisions that will most effectively employ these resources in order to gain

a superior position in the market. Any item, including a simple pencil, represents the application and coordination of a nearly infinite array of resources and activities (see Figure 3-1, "I Pencil"). No one entity — even if it were staffed by the top graduates of the top business schools — can effectively coordinate all the resources it takes to manufacture a simple pencil, let alone a complex weapon system. One key to attaining a competitive advantage is to determine where the business should position itself, given its resources, to create value and then capture a portion of the value created.<sup>3</sup>

The lesson we draw from "I Pencil" is that assembling and controlling all the resources to make a pencil would be capital-intensive and require a wholly unworkable administrative hierarchy. Instead of one vast vertically integrated firm, many firms are involved in various aspects of pencil manufacturing. Additionally, market forces control the activities of these many companies far more effectively than one central entity could. To secure a place in the writing instrument business, the pencil manufacturer can rely on other firms to produce the necessary inputs. The company need not integrate into forestry, graphite mining, and heavy equipment manufacturing. Other companies specialize in these markets.

But for a moment assume that the (fictitious) ABC Pencil Company did decide to backwards integrate into these activities. In addition to the cost of the fixed assets, administering such a conglomeration of business activities would be exceedingly burdensome. Corporate staffs to oversee these diverse activities represent a cost to the firm. Still more costs are involved in a myriad of coordination matters such as transfer pricing, combining purchases, and consolidating financial statements. Such home office functions are, in essence, information processing activities and they come with a cost that must be allocated to the goods the business

### Excerpt from "I Pencil"<sup>4</sup>

I am a lead pencil — the ordinary wooden pencil familiar to all boys and girls and adults who can read and write.

Writing is both my vocation and my avocation; that's all I do.

Simple? Yet, not a single person on the face of this earth knows how to make me. This sounds fantastic, doesn't it? Especially when it is realized that there are about one and one-half billion of my kind produced in the U.S.A. each year.

Pick me up and look me over. What do you see? Not much meets the eye — there's some wood, lacquer, the printed labeling, graphite lead, a bit of metal, and an eraser.

#### Innumerable Antecedents

Just as you cannot trace your family tree back very far, so is it impossible for me to name and explain all my antecedents. But I would like to suggest enough of them to impress upon you the richness and complexity of my background.

My family tree begins with what in fact is a tree, a cedar of straight grain that grows in Northern California and Oregon. Now contemplate all the saws and trucks and rope and the countless other gear used in harvesting and carting the cedar logs to the railroad siding. Think of all the persons and the numberless skills that went into their fabrication: the mining of ore, the making of steel and its refinement into saws, axes, motors; the growing of hemp and bringing it through all the stages to heavy and strong rope; the logging camps with their beds and mess halls, the cookery and the raising of all the foods. Why, untold thousands of persons had a hand in every cup of coffee the loggers drink!

The logs are shipped to a mill in San Leandro, California. Can you imagine the individuals who make flat cars and rails and railroad engines and who construct and install the communication systems incidental thereto? These legions are among my antecedents.

Consider the millwork in San Leandro. The cedar logs are cut into small, pencil-length slats less than one-fourth of an inch in thickness. These are kiln dried and then tinted for the same reason women put rouge on their faces. People prefer that I look pretty, not a pallid white. The slats are waxed and kiln dried again. How many skills went into the making of the tint and the kilns, into supplying the heat, the light and power, the belts, motors, and all the other things a mill requires? Sweepers in the mill among my ancestors? Yes, and included are the men who poured the concrete for the dam of a Pacific Gas & Electric Company hydroplant which supplies the mill's power!

Don't overlook the ancestors present and distant who have a hand in transporting sixty carloads of slats across the nation.

Once in the pencil factory — \$4,000,000 in machinery and building, all capital accumulated by thrifty and saving parents of mine — each slat is given eight grooves by a complex machine, after which another machine lays leads in every other slat, applies glue, and places another slat atop — a lead sandwich, so to speak. Seven brothers and I are mechanically carved from this "wood-clinched" sandwich.

My "lead" itself — it contains no lead at all — is complex. The graphite is mined in Ceylon. Consider these miners and those who make their many tools and the makers of the paper sacks in which the graphite is shipped and those who make the string that ties the sacks and those who put them aboard ships and those who make the ships. Even the lighthouse keepers along the way assisted in my birth — and the harbor pilots.

(continued)

Figure 3-1. "I Pencil"

The graphite is mixed with clay from Mississippi in which ammonium hydroxide is used in the refining process. Then wetting agents are added such as sulfonated tallow — animal fats chemically reacted with sulfuric acid. After passing through numerous machines, the mixture finally appears as endless extrusions — as from a sausage grinder — cut to size, dried, and baked for several hours at 1,850 degrees Fahrenheit. To increase their strength and smoothness the leads are then treated with a hot mixture which includes candelilla wax from Mexico, paraffin wax, and hydrogenated natural fats.

My cedar receives six coats of lacquer. Do you know all the ingredients of lacquer? Who would think that the growers of castor beans and the refiners of castor oil are a part of it? They are. Why, even the processes by which the lacquer is made a beautiful yellow involves the skills of more persons than one can enumerate!

Observe the labeling. That's a film formed by applying heat to carbon black mixed with resins. How do you make resins and what, pray, is carbon black?

My bit of metal — the ferrule — is brass. Think of all the persons who mine zinc and copper and those who have the skills to make shiny sheet brass from these products of nature. Those black rings on my ferrule are black nickel. What is black nickel and how is it applied? The complete story of why the center of my ferrule has no black nickel on it would take pages to explain.

Then there's my crowning glory, inelegantly referred to in the trade as "the plug," the part man uses to erase the errors he makes with me. An ingredient called "factice" is what does the erasing. It is a rubber-like product made by reacting rape-seed oil from the Dutch East Indies with sulfur chloride. Rubber, contrary to the common notion, is only for binding purposes. Then, too, there are numerous vulcanizing and accelerating agents. The pumice comes from Italy; and the pigment which gives "the plug" its color is cadmium sulfide.

#### **No One Knows**

Does anyone wish to challenge my earlier assertion that no single person on the face of this earth knows how to make me?

— Leonard E. Read

"I, Pencil" by Leonard Reed is reprinted with permission of the Foundation for Economic Education. It can be found in its entirety at: <http://www.fee.org/about/ipencil.html>

**Figure 3-1. "I Pencil" (continued)**

produces. Instead of internalizing these functions and activities, market forces, through the invisible hand of a free economy, process information far more efficiently than a staff of people trying to orchestrate them (see Figure 3-2, The Problem With Planned Economies).<sup>5</sup> Resources are moved to where they are needed by the forces of the market.

Finally, while more difficult to measure, there is also a cost in lack of management focus and

purpose. Are we a pencil company? Are we a logging company? Are we a mining company? What is our core function? Reliance on the market allows the company to focus on a specific range of activities that it does best. This boils down to the old truism: you can do a few things well or many things poorly.

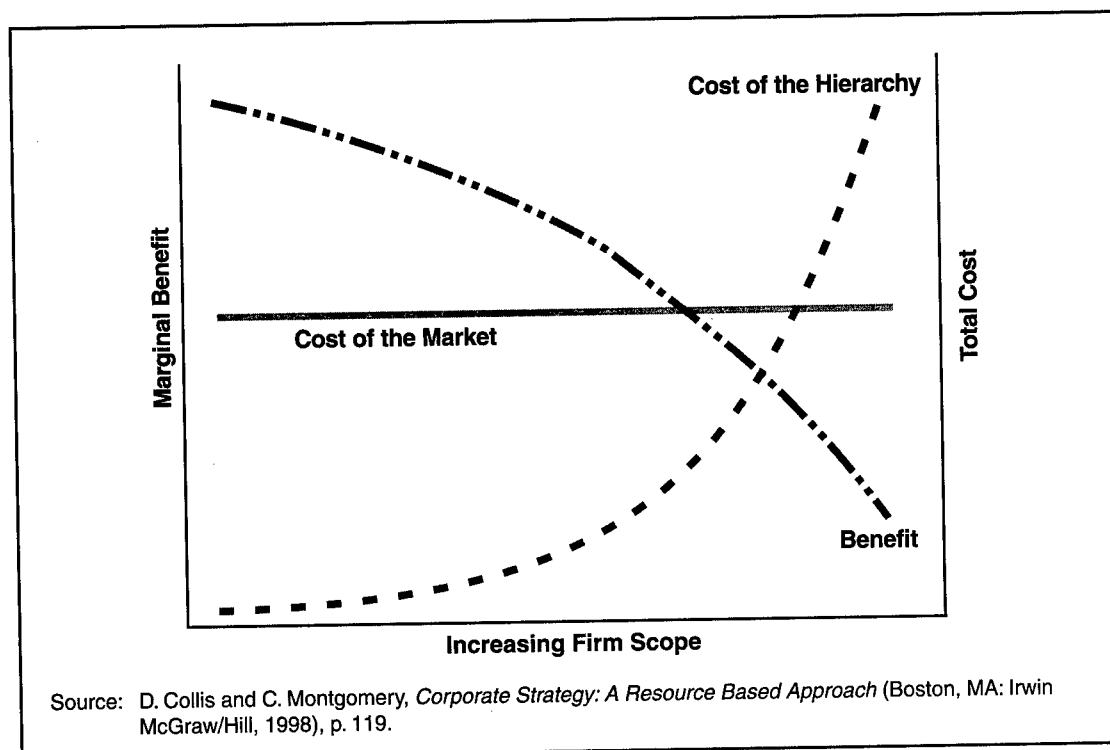
"I Pencil" is, of course, an extreme example but it is provided to illustrate a point. Firms do not necessarily gain competitive advantage

Bureaucratic inefficiency is not unique to business. Communist states, with their planned economies saw their domestic production outstripped by market economies. While in theory a planned economy could reach an optimal production plan if the central planner knew production possibilities of all the firms, in practice such information was not available and the bureaucratic apparatus could not keep pace with market forces. Additionally, when workers do not reap the benefits of their productivity, incentives shift from maximizing profits to maximizing their own welfare.<sup>6</sup> Economists use the term moral hazard to describe this behavior. Moral hazards also apply to the planners. Bureaucrats seek to maximize their welfare by expanding the size, rather than the value creation, of their agencies. In much the same way that companies compete for market share, bureaucrats compete for finite public funds.<sup>7</sup> This applies not just to communist societies. It is prevalent in all public agencies and is often cited as a reason for privatization of government services in the United States.<sup>8</sup> Any entity run as a cost, vice a profit, center is vulnerable to moral hazards.

**Figure 3-2. The Problem with Planned Economies**

through integration and control. In fact, by needlessly integrating, management may lose control. Instead, firms gain a competitive advantage by understanding the tangible, intangible, and capability resources at their disposal and how most effectively to apply them.

In economic terms, this means a business must understand not only the benefits of integration but also the relative costs. This is especially difficult in the public sector where resources are measured in terms of consumption rather than in terms of the marginal value they produce. Figure 3-3 graphically displays this relationship.



**Figure 3-3. Limits to the Size of the Firm**



Note that as the scope of the firm expands, so too do the administrative/hierarchy costs. Ensuring that the costs of performing the activity do not exceed either the benefit derived or the market price of the good or service is critical to integration or outsourcing calculations. Too often, companies (DoD included) do not capture the hierarchy/governance costs associated with integrating or divesting the activity. Instead, the focus is only on the direct inputs involved. The rationale is often framed in these terms: Company X wants to charge me \$100/week but if we were to perform this function, calculations indicate it would only take two of my people a total of four hours a week at \$20/hour plus \$10 per week in materials. One hundred dollars vs. ninety — let's do the work in-house.

Unfortunately, this approach leaves many elements out of the calculation. Can our people do the job as well? What are the missed opportunities of not employing these people four hours a week on other activities? What is the cost of the shifting work schedules around this new activity? Is four hours an over-optimistic number? What oversight costs does this new activity represent? Just as behind the warrior there lies a support structure, behind the laborer there lies a similar support structure. These administrative and governance costs must be recognized in any financial assessment. Unfortunately, these costs are often difficult to measure (see Figure 3-4).

When initially implementing an activity, management generally has a clear understanding of the direct costs to the firm. The budgeting process accounts for the cost of additional personnel, office equipment, facilities, etc. However, the governance costs associated with the new activity are far more difficult to capture. The firm may estimate that 20 percent of a manager's time is spent on the new activity and allocate cost accordingly, but this is only an estimate. Even if this figure were completely accurate, what other activities might suffer because management attention was diluted by 20 percent? Unfortunately, organizational dynamics are not as organized and compartmentalized as accounting models would indicate. With one-fifth of management attention gone, other activities may suffer by a proportional or a non-proportional amount.

When making an outsourcing decision, it is equally difficult to determine the governance costs associated with the activity to be moved outside the firm, especially if that function is integrated or divested incrementally. While Activity Based Costing (ABC) and other techniques have helped to put a price tag on activities, such systems measure not the activity but more accurately, the capacity for performing that activity.<sup>9</sup> Reversing the previous situation, it's easy to eliminate the direct costs of an activity but difficult to get rid of 20 percent of a manager. Increased management focus on the remaining activities may provide a benefit, but projected benefits are difficult to predict and are not generally addressed in traditional business case analysis.

Of course, increasing the capacity of an accounting system to more accurately measure governance costs might produce a more accurate business case but to do so would represent an additional hierarchical cost in and of itself. The cost of an accounting system built to ever increasing levels of detail would rapidly exceed the benefit to management.<sup>10</sup> These systems are abstractions that will never be completely accurate in their ability to identify the costs associated with governance activities. They will never be able to completely capture the missed opportunity costs of employing resources (labor or capital) for one function and forgoing another. No one can know with certainty the true costs of an activity.

**Figure 3-4. Capturing Governance Costs with Accounting Systems**

## Analysis of Vertical Integration<sup>11</sup>

Clearly, there are diminishing returns to the firm as it expands into more and more areas. How then does a firm decide what activities it will integrate and what activities it will look for in the marketplace? In their book, *Corporate Strategy*, David Collis and Cynthia Montgomery offer a series of steps that help to frame this decision process. This model is depicted in Figure 3-5 and described in the following paragraphs.

### ***Step One – Disaggregate the Supply Chain***

The first step in this analysis is to disaggregate the industry supply chain into all the steps that are physically capable of being separated. This includes not only production activities but also support and infrastructure activities such as data processing, payroll, facilities maintenance, procurement, logistics, etc. Once this is done, each activity can be carefully evaluated by posing a series of questions.

### ***Step Two – Assess the Market***

Is there a reliable market that can provide the goods or service? What is the capacity of the market? Is there a possibility that the market could fail or be taken over by a competitor? These are among the questions that must be posed in order to gauge the availability and dependability of providers outside of the firm. If there is no viable market, the activity must be performed internally, an outside supplier (or suppliers) developed, or the activity may be discontinued. If, on the other hand, there are only one or two other sources, suppliers might hold the company hostage, demanding high prices, or a competitor could buy up market capacity to gain an advantage.

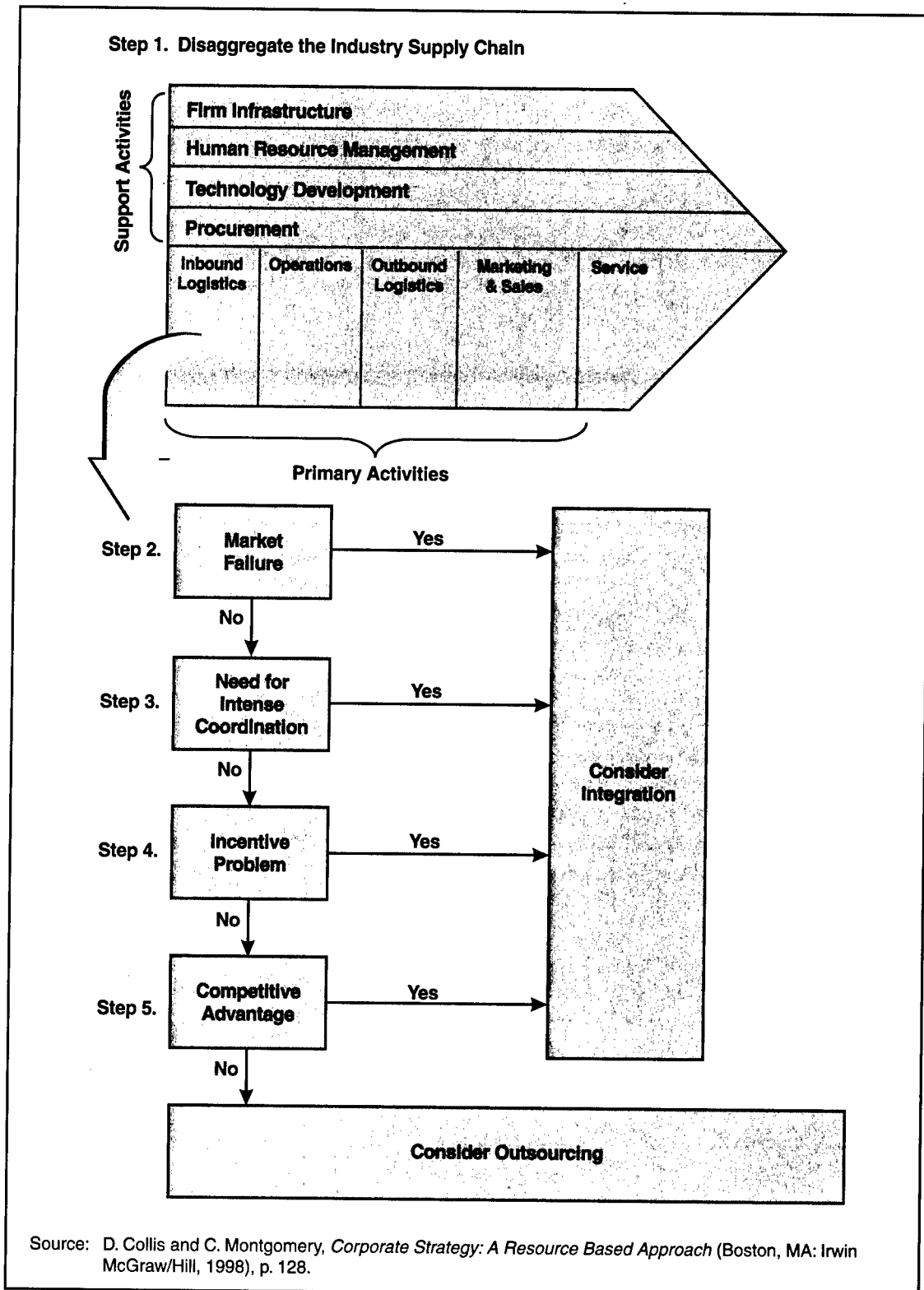
This applies not only to protecting current market share but also staking out potential

markets. This was exactly what happened when a small company named Minnetonka developed Softsoap® liquid soap. Big industry players such as Procter & Gamble and Colgate-Palmolive soon noticed the success of this product. However, they were precluded from entering the market because, in a strategic move, Minnetonka had locked up the total annual production of the only two suppliers who manufactured a critical element of the soap bottle: the little plastic pump. This represented a \$12 million order — at the time, more than Minnetonka's net worth. However, the gambit was successful. Lacking the pump, competitors could not enter the market. This gave Minnetonka 18 months to establish and maintain a strong market position.<sup>12</sup>

If there is a chance the market will fail, the activity may have to be integrated. This is often more expensive but the extra cost mitigates risk. This may mean complete integration so that the capacity of the integrated activity can satisfy all firm requirements or it may mean a partial integration so that the firm will retain a safety production capacity in the face of a partial market failure.

### ***Step Three – Assess the Need for Coordination***

If there is a viable market and no strategic risk of failure, the next step is to determine if a need exists for intensive coordination. Examples of coordination needs are products that may need to be jointly modified in order to maintain successful interface and integration. This is particularly critical in cutting edge technologies where breakthroughs are dependent on modifying numerous components simultaneously. For years IBM worked on this principle. Advances in its mainframe computers were coordinated among internal hardware manufacturing, operating system development, application software, sales, and service. Closed



**Figure 3-5. Choosing the Scope of the Firm**

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architecture and vertical integration propelled IBM to the top of the mainframe market and for years was the mainstay of the IBM Empire. Later, in a strategic blunder, IBM broke this structure without taking into account the consequences.<sup>13</sup>

#### ***Step Four – Assess the Importance of Incentives***

Given that there is no market failure and no need for coordination that can't be gained through market mechanisms (i.e., spot markets, long-term contracts, alliances, or joint ventures), management must now examine the benefit derived from maintaining the activity in-house against the cost. Governance costs must be assessed and compared to the benefit. For example, in a manufacturing plant, employing an electrician may be beneficial in that the person works exclusively for the company and is on call anytime there are electrical problems. Having equipment down is costly. The inventory costs associated with activity are likely small, and governance costs insignificant. Furthermore, there is an effective incentive scheme to insure a sufficient level of performance. If the electrician's work is unsatisfactory, there are other qualified electricians who can be hired.

But sometimes the governance costs are high and reliance on the market would provide for a more effective incentive system. In the last example, we cited the example of an electrician. Now let's consider grounds maintenance of a large facility such as a college campus where there are considerable fixed and governance costs. Equipment must be purchased and maintained. A supervisor is needed to schedule, inspect, hire and fire. Additionally, incentives do not work as well. We could hold the individual electrician accountable for all electrical work performed. Now accountability is spread to a whole department and operating the grounds

maintenance department as a cost center means that there is not a strong incentive to garner a high return on the resources allocated as is the case with a profit center. In this instance, outsourcing provides a stronger incentive system. A grounds maintenance contract eliminates the need for investment in equipment and management of an activity. Additionally, management need not be focused on such ancillary activities as cutting the grass.

Leveraging market incentives applies not only to support activities typically thought of as overhead, but also to direct activities. This is the idea behind franchising. A company like McDonalds, in order to maintain a world-wide chain of restaurants, would face huge capital expenditures. Additionally, once built, McDonalds likely could not institute an enterprise-wide incentive system that would garner optimal performance. Instead, the mechanism of franchising taps into local capital and the market provides the franchise owner with entrepreneurial incentives that are more powerful than could be administered by the corporation. Franchising also carries the advantage of spreading risk and allows for more rapid market growth than would otherwise be possible.<sup>14</sup>

#### ***Step Five – Determine if the Activity Will Garner a Competitive Advantage***

This is the most critical element of this decision model. Even if one were able to measure integration costs and benefits with complete accuracy, the information would not be sufficient to make an outsourcing or integration decision. The business environment is fluid, not static. Economic models are snapshots of data, and economic analysis typically assumes rational players and generally isolates one variable while holding all other things equal. However, players aren't always rational, and all things are not necessarily equal. The game is

always changing, and businesses must take into account the movement and actions of competitors, suppliers, customers, and complementors.<sup>15</sup> When asked the key to his success as a hockey player, Wayne Gretzky stated that he doesn't skate to the puck, rather he skates to where the puck will be. As we saw in Chapter One, the world marches on at an increasingly dizzying pace. The range of opportunities and the business theory and models to exploit them are constantly changing. Understanding and conceptualizing these dynamics is the key to gaining a competitive advantage.

In addition to market dynamics, there are other powerful considerations that must be addressed. These considerations go beyond a clinical view of resource employment, market failure, incentives, and transaction costs, extending to elements that, while more difficult to measure, have more power over an organization. These are the elements that allow organizations that possess the same resources to perform on different levels, and they go back to the basics of strategy development.

In Chapter Two, we outlined an order of precedence that began with belief systems, vision, and mission. From these elements, strategy is developed; and from strategy, structure is derived. Therefore, before continuing a discussion of how industry makes integration and outsourcing (i.e., structural) decisions, we need to explore the dynamics of the elements from which business strategies are developed. In the following paragraphs, we describe elements in the strategic equation that must be understood before beginning an outsourcing or an integration exercise.

### **Creating and Capturing Value**

As discussed in Chapter Two, the object of strategy is to position the business in such a way that

it can capture value in a fluid environment that is affected by the actions and interactions of various players (i.e., suppliers, buyers, competitors, substitutes, complementors, new entrants, and the government/public). This is far more challenging than a zero sum game like chess where there are only two players, and only one winner and one loser (or a draw). The business world, in contrast, represents a positive sum game, which can be far more rewarding. When optimally structured, business creates value. There can be many winners.<sup>16</sup>

Positioning the business in such a way that it interacts with other businesses to create value makes capturing value a much easier proposition. In their book, *Co-opetition*, Adam Brandenburger and Barry Naelebuff make the point that business is not war, nor is it peace. Instead, business is about understanding the value that each player brings to the table. Understanding this value proposition is an essential element in determining the best position for the business to occupy.

Businesses and individuals typically make these value determinations without necessarily linking them to strategy. For example, management understands it needs a set of talents and skills in order to operate. It can acquire those talents or skills through hiring or it can develop them within the current pool of employees. People are then placed into positions where their individual expertise will produce the most economic benefit for the present or they are put in training programs where the talents developed will gain the firm benefits in the future. Airlines, for example, hire pilots to fly because this is where most value is derived from their skills. The same is true for trained mechanics, flight attendants, and investors. Each contributes a resource and each expects a return based on the comparative value that he or she brings to the table.

The top domestic and international carriers rated in a survey of airlines and their services. Top reputation rating = 100.		
Rank	Airline	Rating
1	Southwest	75.0
2	Delta	70.0
3	American	69.5
4	United	67.2
5	Continental	66.0
6	Northwest	65.9
7	America West	64.8
8	Trans World	63.3
9	US Air	62.9
10	Alaska	61.6

**Table 3-1. Rating the Airlines**

The fact of the matter is that these players will receive a return based not on what resources they bring, but on what value the firm creates and what value the firm can capture with those resources. Combined in the right way, these resources create value. To the flying public, that value represents a service they are willing to pay for. Some airlines are more successful than others, not because they have greater resources but because they are structured and positioned in such a way to provide greater value to the consumer. Witness tiny Southwest Airlines. This Dallas-based airline enjoys a strong reputation and consistently scores at the top of travel surveys and rankings of most-admired companies (See Table 3-1). Additionally, it has the lowest rate of complaints filed at the U.S. Department of Transportation (DOT), year after year.<sup>17</sup> Southwest receives top ratings not because it has more planes or more terminals or more amenities but because it offers low prices on point-to-point routes and airplanes that run on a reliable schedule. Put another way, it offers better value.

Some, especially in DoD, may be tempted to say the key to Southwest's success is its low price structure, but this ignores the fact that many other airlines have tried to imitate Southwest's business model, yet they haven't attained the success Southwest enjoys. Southwest is able to take the same inputs available to any other competitor and create a better value. Why? It stems from the fact that value creation goes beyond totaling the sum of the parts. In the value creation process, organizations combine not one but three essential ingredients: resources, processes, and culture.<sup>18</sup>

Resources, as we have stated, are inputs brought to the table by the individual players. Processes (or what Collis and Montgomery termed *systems*) refer to the mechanisms for combining and arranging these resources. Much attention has been focused on process improvement in the business community and in DoD. Process improvement programs such as Total Quality Management (TQM), Just-in-Time (JIT), and Enterprise Resource Planning (ERP) are aimed

at creating efficient, reliable processes that will generate the greatest yield in quantity and quality for any given input.

There is a third ingredient — culture — that is less tangible but acts as a significant multiplier of resources and processes in the quest for value creation. Culture is deeply rooted in the beliefs and values of the organization and it is arguably the reason why, given similar resources and processes, other airlines have not matched the value Southwest creates and captures.

For those of us in DoD, there are many examples of the power of culture that are closer to home. Take two ships, two fighter squadrons, or two infantry brigades. Each has approximately the same resources and the same processes yet one consistently outperforms the other. Why? It is because the command culture of one unit is superior to that of the other. Be they soldiers, sailors, airmen, or marines, they are outperforming their counterparts because of this intangible force.

Instilling this culture is, of course, a primary function of leadership and part of what distinguishes leadership from management. Intangibles cannot be managed in — nor can effectiveness. Leaders are the people who *do the right things*. The function of management, on the other hand, emphasizes *doing things right*. Strategy starts with leadership.

Understanding the broad context of the previous discussion is critical to any discussion of outsourcing. Successful companies outsource

as a tool by which to focus their resources, processes, and culture on the value creation process. But this is a double-edged sword. Outsourcing can also contribute resources that are lower priced but of less value. Outsourcing can integrate processes that, while less expensive, are inferior. Most devastating of all, outsourcing has the potential to weaken the beliefs and values that make up a strong corporate culture. Conversely, integrating — bringing activities in house — and not outsourcing can dilute valuable resources; maintaining too many activities can skew processes; and doing too many things can weaken an organization's culture. Keeping this in mind, it becomes easier to understand why cost reduction is not the primary objective of outsourcing decisions and why integrating too many activities can have an equally adverse effect.

### Strategy Drives Structure

In the last chapter we discussed the Kodak Corporation. Its vision is to *“be the World Leader in Imaging.”* From this vision flows Kodak's strategic objective: to be unique. This differentiation is one of the three generic strategies that Michael Porter lists in his two books: *Competitive Strategy* and *Competitive Advantage*. In addition to differentiation, Porter describes two other generic strategies: cost leadership and focus (see Figure 3-6).<sup>19</sup> While there are obviously variations on these strategies as they are applied from one company to the next, they serve as a good reference point for a discussion of basic strategy and how the structure of the firm is tailored to that strategy.

Porter's Three Generic Business Strategies		
Differentiation	Focus	Cost Leadership

Figure 3-6. Generic Strategies

## Differentiation

Firms sell to markets where there can be many competitors. The advantage of a firm pursuing a differentiation strategy is that it is perceived to be unique and set apart in some way. A firm pursuing such a strategy will make a determination of what buyers value in a given industry.<sup>20</sup> Providing this value sets the firm apart from its competitors and it is also by providing this unique value that the firm is able to charge a premium price. This is why Kodak does not compete on price. Kodak competes on quality. This quality may be real or perceived. Many companies offer products that are arguably of no better quality than that of its competitors but these companies have successfully communicated an illusion of superiority. Customers acting on this perception will exhibit a preference in their buying habits. Even though there is no discernable difference in the products, customers associate the product with value.

## Brand Image

This is why a company that differentiates takes great care to build, cultivate, and reinforce a strong brand image. It is the brand that communicates the value of the product to the consumer, and it is the reason that acquiring firms will pay a premium for a company

product or service with a strong brand name (see Figure 3-7). Differentiators take great care to ensure the brand name communicates value. This is no accident. It is part of a deliberate strategy and companies that become distracted from this strategy tend to suffer. This is exactly what happened to Black and Decker when they acquired the Housewares Division of General Electric (GE) in 1984. In their move “from the garage to the house,” the Black and Decker brand name was applied to such items as vacuum cleaners, irons, and toaster ovens. This had a disastrous effect on sales of Black and Decker’s line of power tools, especially among skilled tradesmen (plumbers, electricians, carpenters, etc.). The Black and Decker brand name did not elevate the status of Dustbuster® vacuum cleaners. Instead, it diminished the perceived quality of a heretofore-respected line of power tools.<sup>21</sup>

Black and Decker’s experience resonates in two respects. First, it shows the power of a brand and what can happen if that brand is diluted. Secondly, it shows that even if the acquisition of GE Housewares made sense on paper, there are some powerful intangible forces that must be taken into consideration even if they are not readily measurable. Black and Decker’s strength was its expertise in tools and hardware. This translated into a brand name and line of

In many instances, intangible assets such as patents or a strong brand command a premium when the firm is acquired by another entity. This is because, just as a secure patent offers a competitive advantage, so too does a good name. Goodwill represents the price an acquiring firm will pay over the fair market value of the target company’s assets. Goodwill is recorded on the balance sheet and then amortized over a number of years. This phenomenon also helps to explain why the market value of a company’s stock may exceed the book value of the firm, even when the value of future earnings are taken into consideration.<sup>22</sup> This is why when Sandoz Ltd. acquired Gerber, a maker of baby food with a strong brand name and 70 percent of the U.S. baby food market, it was willing to pay \$3.7 billion or 33 times Gerber’s annual profits.<sup>23</sup>

**Figure 3-7. Goodwill**



products that denoted quality. This was their competitive advantage. By expanding into a line of home appliances, this advantage was lost.

Brand image not only helps to sell products, it is also a powerful force for attracting talent. People who want to be the best in their chosen career fields are attracted to organizations that have a reputation for being the best. The top accounting firms, the most respected law firms, and the leading technology firms are at an advantage when recruiting the best accountants, lawyers, and engineers. However, this advantage is nullified when these companies recruit talent in areas where their brand doesn't apply (e.g., a technology leader hiring highly talented lawyers).

### **Integrating and Outsourcing**

With this in mind, those pursuing a differentiation strategy should avoid integrating into areas that might dilute the value of its brand and products (value being defined by the customer). Conversely, the differentiator may consider outsourcing into areas that strengthen or reinforce that value. This explains why firms may outsource activities that may be performed more economically in house. For example, if customers value fast delivery, a firm may consider outsourcing logistics and manufacturing functions if doing so shortens delivery time. This is because the firm focuses not on cost but on the premium it can demand for faster service.

Outsourcing may also be a mechanism to allow managers to concentrate on areas that customers value. In the case of Kodak, outsourcing automated data processing (ADP) allowed the company to concentrate on what Kodak is known for: quality imaging. For the differentiator, the enhancement of its ability to set itself apart is at the crux of any outsourcing

decision. For the differentiator, this is the path to advantage and profitability.

### **Cost Leadership**

A second generic strategy identified by Porter is cost leadership. We spend considerable time on this strategy because while it seems clear, there are numerous strategic implications to consider. Pursuing cost leadership without understanding these implications has been the downfall of many of the companies we have studied. Before delving into how cost leaders structure their companies and make integration and outsourcing decisions, it is important to step back and apply some of the strategic analysis introduced in Chapter Two.

### **Market Analysis**

Firms seek to gain a competitive advantage through lower cost. The assumption is that the customer values low price above all else. This is a critical assumption and one that should not be taken lightly. Often only one segment of the market makes a buying decision solely on price (for example people who buy generic or private label aspirin versus national brands). Market analysis may point to other segments of the market that value aspects other than price. These segments may offer more lucrative opportunities.

After competing on price alone, Mobil® Oil, a refiner and gas retailer, used market research to ascertain that only 20 percent of buyers valued price alone. Instead of going after this fickle 20 percent, Mobil went after a larger segment of the market that valued things other than price. Table 3-2 lists these segments.

Instead of a cost leadership strategy that would target Price Shoppers, Mobil pursued a differentiation strategy aimed at Road Warriors, True Blues, and Generation F3s. This represented

Segments in the Retail Gasoline Market		
Segment	Market Representation	Characteristics
Road Warriors	16%	Higher-income middle aged men who drive 25,000-50,000 miles a year...buy premium gasoline with a credit card...purchase sandwiches and drinks from the convenience store...will sometimes wash their cars at the car wash.
True Blues	16%	Usually men and women with moderate to high incomes who are loyal to a brand and sometimes to a particular station...frequently buy premium gasoline and pay in cash.
Generation F3	27%	Fuel, Food, and Fast: Upwardly mobile men and women — half under 25 years of age — who are constantly on the go...drive a lot and snack heavily from the convenience store.
Homebodies	21%	Usually house wives who shuttle their children around during the day and use whatever gasoline station is based in town along their route of travel.
Price Shoppers	20%	Generally aren't loyal to either a brand or a particular station, and rarely buy the premium line...frequently on tight budgets.
Source: R. Kaplan and D. Norton, <i>The Balanced Scorecard</i> (Boston, MA: The Harvard Business School Press, 1996), p. 66.		

**Table 3-2 Customer Market Segmentation of the Retail Gasoline Market**

the most profitable 59 percent of the market. Mobil stations were revamped to offer food and bottled drinks, a selection of gasoline grades, and pay-at-the-pump features that included Mobil's *Speedpass*® a device that allows a customer to pay by simply placing a pre-purchased debit card against the pump chase.

This example is provided to illustrate that one should not assume all customers are the same, that customers value only price, or that cost leadership is the only viable strategy. Customers are constantly making value determinations. Gas may sell for ten cents less at a station located 30 miles away; however, you may value

your time more than the marginal price difference. A traditional grocery store may offer lower prices, but for a small purchase, the quick transaction offered by a convenience store may be preferable. By asking the simple questions: who are our potential customers? and what do they value? a business may quickly discern the rudiments of a better strategy.

### Strategic Implications

Expanding outside of retailing to inter-firm sales, a strategy of cost leadership takes on additional dynamics that should be taken into consideration. Remember from Chapter Two

the example of Holland Sweetener. It entered into a market where the major customers (Coca-Cola® and Pepsi-Cola®) truly did value price. Instead of using techniques such as game theory to think through how various scenarios might play out, Holland went head-to-head with Monsanto in a brutal price war. The result was that Coke® and Pepsi® got what they wanted — aspartame savings totaling \$200 million a year but Holland received little of the profit that prompted its entry into the market. A far more effective move for Holland would have been to approach these soft drink manufacturers before entering the market and ask to get paid to enter the market. Holland, at this point, would have been in a strong negotiation position. Coke and Pepsi, valuing price, would have likely paid a portion of the projected aspartame savings for Holland to enter the market as a spoiler, knowing the entry of a competitor would drive down price.<sup>24</sup>

### **Other Considerations**

Understanding what the customer values, how to create that value, and then how to capture a portion of the value created are essential to any strategy.<sup>25</sup> Having made this point, let's assume that a given firm has conducted the requisite strategic analysis and has decided to embark upon a strategy of cost leadership. While this may seem a clear strategy, there are some important considerations. First of all, differentiation cannot be ignored. The product or service must have the same overall quality as is found throughout the industry.<sup>26</sup> Customers are constantly making value assessments. If a difference can be discerned, a trade-off calculation is inevitable.

This brings out the second point: it is advantageous to have competition in the market. Without competition, there is no easy price comparison. Without competition, there are no market forces to motivate and enforce disciplined

cost analysis. And, as Alfred P. Sloan well understood, and Bill Gates apparently did not, without competitors there is the risk of government anti-trust action.<sup>27</sup>

Not only is it advantageous to have competitors, it is especially advantageous to have big dominant competitors that can provide a cost umbrella. These firms typically set the market price by virtue of the fact that they have the biggest share of the market.<sup>28</sup> With this umbrella the non-dominant player need not price at a low margin. Instead, it can price at or near the established market price. Dominant competitors also tend to pay more attention to attractive market segments where margins are high, leaving difficult segments vulnerable to exploitation.<sup>29</sup>

### **Vulnerability of Cost Strategies to Disruption**

This was exactly how mini-mills were able to gain a foothold in the steel industry. Unlike integrated mills that transform iron ore, coal, and limestone into steel products, mini-mills use melted scrap steel as their principal input. This scrap is then fabricated into steel products. Until mini-mill technology became available, integrated mills such as U.S. Steel dominated the industry. These integrated mills dominated because their strategy of integration produced economies of scale that allowed them to compete and win based on the price of their products. These products ranged from sheet steel at the high end of the market to rebar at the low end.<sup>30</sup>

When mini-mill technology was introduced, these mills were only capable of producing products like rebar at the low end of the market where quality requirements are low. Since they did not have sufficient capacity to satisfy the entire market, the price was set by the integrated mills. Since the fixed and variable costs

of a mini-mill are much less than that of an integrated mill, mini-mills could harvest large margins. These margins of course attracted other market entrants and drove existing mini-mill producers to expand capacity. Soon the integrated mills were displaced from rebar. To the integrated mills, this was considered advantageous since it allowed them to concentrate on the higher end of the market.<sup>31</sup>

Unfortunately for the integrated mills, technology marched on. Soon mini-mills were able to produce products that demanded increasing levels of quality. Each time, integrated mills reacted by yielding to the mini-mills until finally these mills were able to produce sheet steel. In retrospect, it would have been a better strategic move on the part of integrated mills to invest in mini-mill technology. Instead they concentrated on the most lucrative end of the market and are now being challenged on price in a market where customers place a high value on price.<sup>32</sup>

As illustrated by the above example, for the business whose strategy is predominately dependent on cost, the world can be an especially cruel place. For firms that pursue this strategy, there is always the risk of retaliation by competitors, or that new business models or disruptive technologies (such as the mini-mill example cited above) will be introduced and exploited to peel away large segments of the market. Sustaining cost leadership requires strategic vigilance of the external environment and strategic analysis of internal structure.

### **Strategic Cost Analysis**

Obviously, as the name implies, a cost leader is focused on driving down internal costs in order to compete effectively. Effectiveness, as we have said, is at the forefront of any strategy, and efficiency is inherently a value proposition.

With this in mind, cost leadership may mean giving up segments of the business that the customer does not explicitly or implicitly value or it may mean a radical restructuring of the business in pursuit of a more effective and efficient business model. It may also entail embracing technologies that show promise.

Porter offers six steps to strategic cost analysis.<sup>33</sup>

1. Identify the appropriate value chain and assign costs and assets to it.
2. Diagnose the cost drivers of each value activity and how they interact.
3. Identify competitor value chains and determine the relative cost of competitors and the sources of cost differences.
4. Develop a strategy to lower relative cost position through controlling cost drivers or reconfiguring the value chain and/or downstream value.
5. Ensure that cost reduction efforts do not erode differentiation or make a conscious choice to do so.
6. Test the cost reduction strategy for sustainability.

Note these steps do not entail squeezing budgets or marginal cost reductions. This process, if followed, may necessitate large-scale adaptation or a complete transformation of the business model. Additionally, the ability to adapt must be quick since a lower price offered by a competitor may translate to rapid erosion of market share. As difficult and painful as this sounds, businesses are increasingly driving toward just this type of transformation to gain competitive advantage.

The potential for transformation to a lower cost structure and the capacity to respond rapidly is precisely the power that is driving the information economy. It allows for radical restructuring of the value chain around more streamlined business models. The revolution in the ability to transact is redefining many value chains in many industries. Take for example the Amazon.com model. Online book purchase eliminates the need for the large fixed costs associated with a chain of retail stores and layers of retail inventory. It also streamlines the variable costs associated with the stores (e.g., staff, utilities, housekeeping, etc.).

Rapid restructuring and adaptation is precisely the strength of the Sense and Respond model described in Chapter One. This model blurs organizational boundaries, changing the dynamics of the firm. Ad hoc virtual firms are now possible consisting of many businesses, electronically linked, engaged in value creation. This capacity not only changes the dynamic of the organization, it changes the dynamic of cost structure. Under this model, assets are no longer defined in terms of fixed and variable. They can now be redefined as committed and flexible.<sup>34</sup>

Committed resources are just what the name implies. These are things the firm is committed to pay for, such as infrastructure, raw materials, contracts, and company salaries. These resources lead to predictable expense being incurred regardless of company output. As such, these resources represent not the cost of production but rather the cost of capacity.<sup>35</sup>

Flexible resources, on the other hand, reside outside the traditional organization and refer to resources the firm may acquire for levels of demand. These are resources available through outsourcing. Because of advances in information technology described in Chapter One, the cost of acquiring a flexible resource outside the

firm is fast approaching the cost of using the resource.<sup>36</sup> This is because information technologies are driving down the cost to transact and share information. With many firms linked together sharing information as well as risk, the cost of excess capacity can be driven from an individual firm's business model.

### **Integration and Outsourcing**

In this context, cost leaders embrace outsourcing. New information technologies allow firms to network or link to companies that position themselves in increasingly specialized areas of the market. Networking allows a company like American Transtech to specialize in telephone service functions. This technology greatly expands the base of clients it may effectively serve and allows for exploitation of scale economies.<sup>37</sup> Conversely, American Transtech's clients are quite willing to turn these functions over since they get better performance. This in turn means better value to the end customer.

What does the customer value? Even to the cost leader, the value proposition remains the essential driving force. A low cost provider with an equally low level of service will likely drive away customers and market share. Successful cost leaders understand this. This is why strategic cost analysis is just that: strategic. By first establishing an effective model, the cost leader gains far more than by making an ineffective model efficient.

### **Focus**

The final generic strategy offered by Porter is focus. This is different from differentiation and cost leadership in that the company is no longer targeting a broad market. Instead, the company is targeting a narrow market segment and will serve this segment to the exclusion of others.<sup>38</sup>

		Competitive Advantage	
		Lower Cost	Differentiation
Competitive Scope	Broad Target	Cost Leadership	Differentiation
	Narrow Target	Cost Focus	Differentiation Focus

Source: M. Porter, *Competitive Advantage* (New York, NY: The Free Press, 1985), p. 12.

**Figure 3-8. Three Generic Strategies**

Firms can attain focus in two ways: cost focus and differentiation focus. While this may sound like a nuance of strategies already discussed, the dynamic of competitive scope separates both types of focus out as a separate generic strategy with two means of execution. This is displayed as a matrix in Figure 3-8.<sup>39</sup>

### Differentiation Focus

There are many ways to attain focus. Close physical proximity to the target segment is one way to attain a differentiation focus. Having a supplier right next door eases communication and allows both companies to align their processes. The location of seat maker Johnson Controls, a few miles away from Toyota's manufacturing plant in Georgetown, Kentucky, eases coordination between the two companies and allows for small frequent deliveries of material rather than large bulk shipments.<sup>40, 41</sup> This proximity model is also used in the world of high technology manufacturing. Many companies that focus on narrow segments of the computer industry locate in the Silicon Valley, not because it provides them with a cost advantage but because this proximity allows them to better serve the market segment they have targeted. The same can be said for DoD support

contractors. Close physical proximity (often in the same office) provides information that helps them to better serve their customers.

In addition to co-location, a company can provide differentiation focus by offering a higher standard of quality. In this case, brand once again takes on an added significance. Ferrari targets a narrow market segment of the auto industry, as does Rolls Royce. Indeed many luxury items follow this model. Fine china, crystal, and designer clothes, are products that appeal to a very narrow segment of the market.

### Cost Focus

Other firms use price as a way to focus on a segment of the market. Factory outlet stores target a small segment of shoppers looking for bargains. Costco and BJ's restrict selection but offer savings on items that they do carry. These items are typically offered in bulk quantities. In addition to companies that focus on retail segments, there are companies that focus on specific industrial segments, using cost as an advantage. This is a particularly successful strategy in a commodity type market. However, as we saw in the Holland Sweetener case, the strategy can backfire.

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## Integration and Outsourcing

By their nature, companies that practice a focus strategy are generally the sources of outsourcing products and services. This is particularly true of companies pursuing a strategy of a differentiation focus. They occupy market niches where they can become highly specialized and offer these specialized products or services to companies that wish to outsource, and they are becoming the giants of the information economy.

Earlier we examined American Transtech, a company that specializes in telephone service products. This is a product that appeals to a very narrow market segment spread across a wide range of industries. Similarly, GE Capital Services focuses on credit card operations for companies that do not wish to internalize this function.<sup>42</sup>

In computing and software, open architecture has enhanced the ability to focus. Intel is focused on the manufacture of computer chips for personal computers (PCs). Microsoft® can focus on software; Hewlett Packard on printers. The ability of many focused entities to collaborate has generated large-scale value coordination. Conversely, the inability for focus and collaboration is largely the reason that Apple Computer has been eclipsed by companies like IBM, Compaq, and Dell.

In the information economy, differentiation focus is becoming an increasingly dominant strategy. Firms with a narrow scope of operations are now able to link together in a virtual organization where information flows freely. Activities, not assets, are emerging as the defining boundary of the organization.<sup>43</sup> Information technology allows these activities to be linked and coordinated independent of the legal definition of the firm.

## Stuck in the Middle

A large number of companies attempt to engage in more than one of these strategies. By doing so, they fail to achieve any of them. Porter refers to these companies as being stuck in the middle.<sup>44</sup> Companies that start out stuck in the middle have no competitive advantage to begin with. Companies that lose sight of their core strategy and drift to the middle soon lose their competitive advantage. Porter writes:

Becoming stuck in the middle is often a manifestation of a firm's unwillingness to make *choices* about how to compete. It tries for competitive advantage and achieves none, because achieving different types of competitive advantage usually requires inconsistent actions. Becoming stuck in the middle also afflicts successful firms, who compromise their generic strategy for the sake of growth or prestige.<sup>45</sup>

Successful firms do not attempt to be all things to all people. Successful companies are the ones that make difficult choices. Unsuccessful companies are ones that refuse to make the difficult choices that are necessitated by adoption of a strategy, or that make disastrous choices that move them away from a successful strategy. We offer two examples of this theory in operation: GE and the Radio Corporation of America (RCA). The former moved itself out of the middle and reaped the benefits. The latter drifted into the middle and suffered the consequences.

## Moving Out of the Middle

Jack Welch has been largely credited with the modern day success of GE. When named Chief Executive Officer (CEO) in 1981, Welch took the reins of a faltering conglomerate with a large and increasingly inflexible bureaucracy.

The company was managed through a well-defined hierarchy that consisted of ten groups, 46 divisions, and 190 departments. Within this structure existed 43 strategic business units designed to support planning for businesses that ranged from mining to oil refining to outdoor lawn equipment.<sup>46</sup> In 1981, GE was truly all things to all people.

Welch worked quickly to reposition the company. He eliminated or sold off large chunks of GE that did not align with his business objectives. In return, he was given the nickname "Neutron Jack," a reference to a weapon that kills only people but leaves buildings standing. However, the message he sent to his employees was clear and unambiguous: "We're either going to be number one or number two or we're going to get out of the business."<sup>47</sup> In other words, GE would be recognized as the world leader in the products and services that bore its name. This trait would differentiate it from its competitors. Welch also began carving away layers of middle management. Believing bureaucracies stifle change and innovation, he went to work removing governance structures and empowering lower-level managers. A series of quotes from Jack Welch is illuminating.<sup>48</sup>

Most bureaucracies — and ours is no exception — unfortunately still think in incremental terms rather than in terms of fundamental change. They think incrementally primarily because they think internally. [When asked about the necessity for such radical restructuring, Welch responded that] the old structure of GE was right for the 1970s, a growing handicap in the 1980s and it would have been a ticket to the boneyard in the 1990s.

We also reduced the corporate staff. Headquarters can be the bane of cor-

porate America. It can strangle, choke, delay, and create insecurity. If you're going to have simplicity in the field, you can't have a big staff at home.

So we got rid of it, along with a lot of reports, meetings, and the endless paper that flowed like lava from the upper levels of the company.

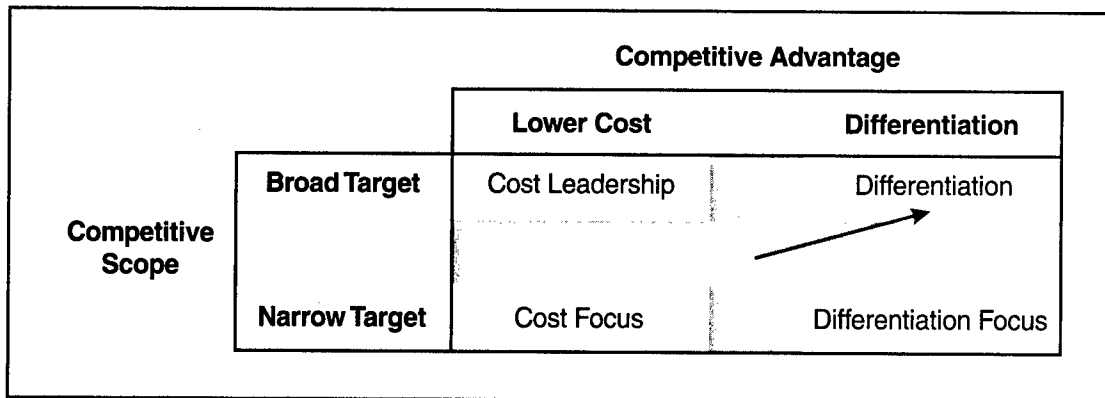
When we did this, we began to see people — who for years had spent half their time serving the system and the other half fighting it — suddenly come to life, making decisions in minutes, face to face, on matters that would have once produced months of staff gyrations and forests of paper.

GE eliminated 59,290 salaried and 64,160 hourly positions between 1981 and 1988. Divestiture eliminated an additional 122,700. Even when offset by acquisitions, total employment declined from 404,000 in 1980 to 292,000 by 1989.<sup>49</sup> Subsequently, GE began a meteoric rise. Between 1981 and 1985, operating profits rose from \$1.6 to \$2.4 billion. In 1990, this figure stood at \$4.3 billion and by 1999, this figure reached \$9.2 billion.<sup>50</sup>

As a result of Welch's actions at GE, the company has enjoyed resounding success and is routinely lauded as one of the best-run companies on the Fortune 500 list. When asked about the speed and severity of GE's restructuring, Welch responded that his only regret was not moving faster than he did.<sup>51</sup>

Arguably, this was a company that had drifted into the middle and had become entangled in bureaucratic processes that permeated the corporate culture of GE. Welch moved quickly and resolutely to shed unproductive resources, instill more effective business processes, and, most important, to instill a culture that valued





**Figure 3-9. GE Moves Out of the Middle**

decisiveness, flexibility, and performance. As a result, GE has moved itself and its businesses out of the middle toward to advantage and profitability as depicted in Figure 3-9. Yet another quote from Welch: “Good business leaders create a vision, articulate the vision, passionately own the vision and relentlessly drive it to completion.”<sup>52</sup>

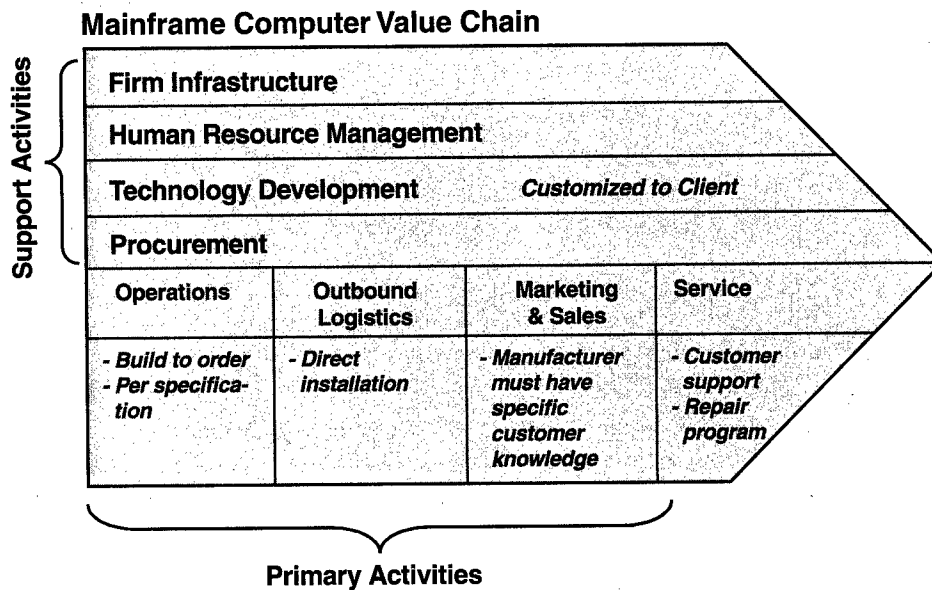
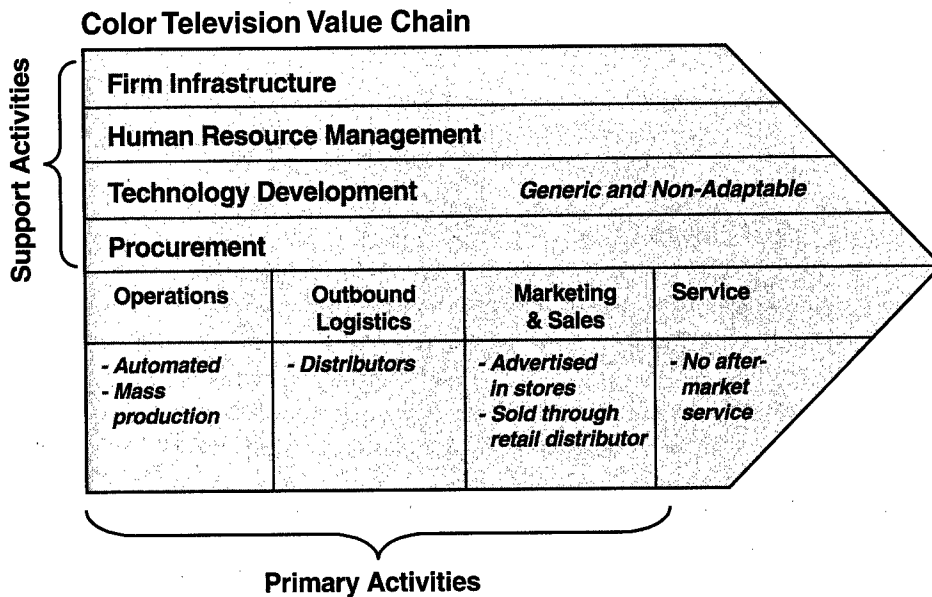
### Drifting into the Middle

Created by the U.S. Government in 1921, RCA became a powerhouse in broadcast media. It was a pioneer in areas such as recorded music, radio, television, and television broadcasting (creating both NBC and ABC).<sup>53</sup> By concentrating in these areas, RCA was able to dominate the radio and television market. At the heart of RCA was a strong concentration on research and development (R&D) within these emerging technologies. RCA’s success in the development of color television technology seemed to solidify its place as an established industry leader.<sup>54</sup>

Then the company moved away from its core strategy. RCA was in the business of providing state-of-the-art telecommunications technology. Using Porter’s framework, this was a form of differentiation focus. RCA was serving a distinct and growing segment (television

and radio) to the exclusion of other technologies and doing quite well. Then from the 1950s to the 1980s, RCA embarked on a series of disastrous decisions that moved it away from its strategy and television market and into oblivion. First, RCA sunk 40 percent of its R&D budget into computers, going head to head with IBM. This was seen as a growing business and with RCA’s respected R&D resources, one where the company thought it would have an advantage. However, while RCA had the technical skill to enter into the computer industry, it did not take into account the rest of the value chain (see Figure 3-10). Marketing and manufacturing computers was entirely different from marketing and manufacturing televisions. IBM, by contrast, did understand this and gained dominance in the market. In 1970, when RCA conceded defeat, it was forced to write off about a quarter of its net worth. During this same time, RCA lost its preeminence in color television technology, ceding dominance to other firms.<sup>55</sup>

A second move away from RCA’s generic strategy was its foray into conglomeration. In its heyday, conglomeration was seen as a means to balance risk over a wide corporate portfolio of activities. Unfortunately, without a central competitive advantage to justify binding the elements of a conglomerate together, the scope



Source: T. McCraw, *American Business, 1920-2000: How It Worked* (Wheeling, IL: Harlan Davidson Inc. 2000), pp. 110-146.

**Figure 3-10. Color Television and Mainframe Computer Value Chains**

of activities exceeds the benefit, placing the individual elements of the conglomerate at a competitive disadvantage. A case in point is RCA, which in the 1960s acquired a host of mismatched businesses including Random House Publishers, Hertz Rent-a-Car, Banquet TV Dinners, and Arnold Palmer Golfing Attire. None of these entities benefited from RCA's now fading edge in R&D. In fact, by squandering precious resources on these acquisitions, RCA further precluded R&D investment.<sup>56</sup>

Finally, RCA decided to put its 6,200 scientists and engineers to work on what was seen as a breakthrough product: the VideoDisk. The company believed that when ready for market, the VideoDisk would sell for much less than a video cassette recorder (VCR) and offer better quality. Unfortunately, what the public valued in the initial days of video was not price. Consumers valued the ability to record. Even at a lower price, the VideoDisk did not offer this feature. The VCR captured the market.<sup>57</sup>

In a fitting postscript, Jack Welch of GE purchased RCA in 1986, then sold off almost all of the company except the NBC television network, which was the target of the acquisition.<sup>58</sup> Such is the power of a sound strategy and the will to follow it. GE flourishes; RCA moved

away from its basic strategy and is no more (see Figure 3-11).

### Strategy and Outsourcing

As we stated at the beginning of this chapter, all firms outsource. Limits to the scope of the firm alone necessitate some reliance on the market. However, outsourcing decisions must be in congruence with the firm's strategic framework. To review, that framework consists of a firm's belief systems, vision, and mission. Within this framework, markets are analyzed and strategy developed. Strategy drives decisions as to how the firm will position itself to attain an advantage. This in turn guides what the firm will and what it will not do.

It follows then that any outsourcing decision begins with an effective strategy. We conclude this chapter with an example of a company that understood this fundamental principle and one that lost sight of it.

### Case Study: Successful Outsourcing

Michael Dell (Dell Computer) built a \$12 billion company in 13 years. This phenomenal success was the product of a strategy that allowed Dell to create value and channel that value directly to the customer. Instead of using

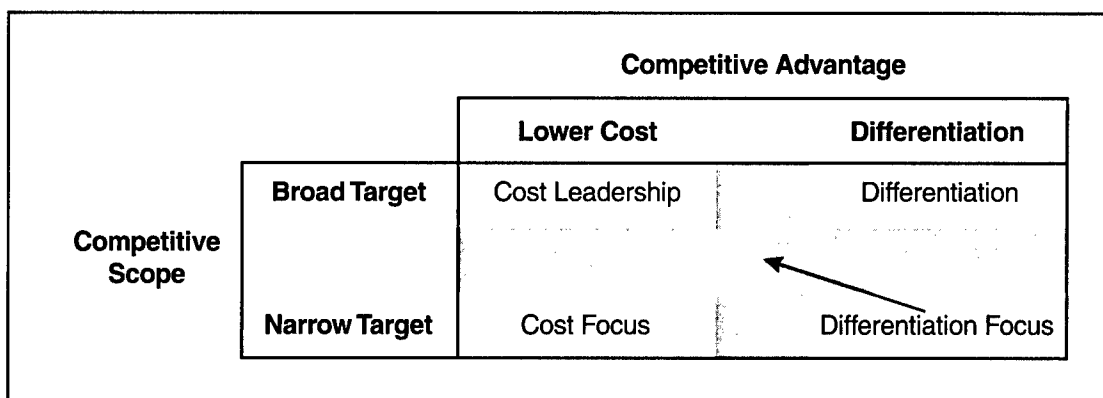


Figure 3-11. RCA Moves Into the Middle

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a dealer channel that relied on a build-to-inventory model, Dell would build to order and sell directly to customers. This eliminated the reseller's markup and the costs associated with carrying large inventories. The buyer would get fast delivery of a computer built to his or her specification. Dell, in return, could charge a substantial margin for the computer and still retain price equity with resellers.<sup>59</sup>

For this model to work, Dell would need a tightly coordinated supply chain. But Dell did not rely on integration to achieve this. Instead, the company leveraged the power of the information technologies to virtually integrate with his suppliers.<sup>60</sup> This was made possible through the direct link that the company had with its customers. Building to order meant that on a day-to-day basis, Dell would know what computers it would be assembling and what components would go into those computers. This information was then shared with its suppliers. Deliveries were directly tied to the production schedule, not to an inventory level.

The virtual integration model necessitates a long-term relationship with Dell and its suppliers. This offers immediate access to customer preference information. For its part, Dell values quality and predictable delivery over price, and it is willing to pay a premium for supplier performance. Additionally, Dell mitigates volatility by ensuring it has a diverse mix of customers and that no one customer represents more than 2 percent of revenues.<sup>61</sup> This garners the supplier a better margin over a longer period.

Not only does Dell outsource component production but also most of its 10,000 field service representatives are contracted from other firms. To the customer requiring after sales service, this relationship is invisible; he assumes he's dealing with a Dell employee.<sup>62</sup>

Another aspect of this model is that by carrying a smaller inventory, Dell can get upgraded products to market more quickly. If Intel comes up with a new chip, Dell, with 11 days of inventory, has a significant advantage over competitors with 80 days of inventory.<sup>63</sup>

Dell's competitive advantage comes from its strategy, and its strategy drives its lean structure. By selling directly to the customer on a built-to-order basis, Dell has positioned itself as an integrator and information processor. Information technology allows it to rely on the market for all else. This makes Dell a company that applies the Sense and Respond Model. Committed resources are minimal — principally its 15,000 employees.<sup>64</sup> Flexible resources are readily available through its virtually integrated suppliers and customer service representatives. By integrating these activities, Dell would lose its competitive advantage.

### **Case Study: Unsuccessful Outsourcing**

As we have seen, IBM dominated the mainframe computer market. Its competitive advantage was the integrated package it provided. IBM built the machines, developed the operating system, wrote the code, installed the hardware, and kept service representatives available to trouble-shoot on behalf of its clients. System architecture was closed and IBM-proprietary. Buying IBM meant that the client bought a complete package.

This was fine with IBM's customers. Since mainframes allowed for automated performance of critical processes such as payroll and account information, it was essential to have these machines up and running. IBM had an army of service technicians, some of whom were posted on-site in the offices of large clients. A single phone call to the IBM representative brought the combined resources of the entire company to bear on any problem, be

it hardware, software, or the operating system. IBM's service and dependability were respected and world-renowned. As testimony to the value of this level of service, it was often said, "No one was ever fired for buying IBM."<sup>65</sup>

Then came the microcomputer. This was truly a disruptive technology.<sup>66</sup> These desktop computers couldn't approach the power and performance of mainframe computers. However, while initially they could not meet the demands of IBM's high-end business market, they were powerful enough for word processing and the maintenance of small databases. This was sufficient technology for households and clerical business functions and, as was the case with mini-mills in the steel industry, the technology was improving, taking the dominant player — Apple — up market. By 1980, just four years after it was founded in a California garage, Apple was the biggest maker of desktop computers in the world.<sup>67</sup> As the demand for desktop computers continued to expand, Apple was poised to reap the benefit.

Realizing this late in the game, IBM decided it had to enter the desktop computer market and fast. This was a decision that had major strategic implications. Up until this time, IBM pursued a strategy that focused on high-end business computer applications. Now it was going to enter a much broader segment of the computer industry. Recall Porter's statement that "achieving different types of competitive advantage usually requires inconsistent actions."<sup>68</sup> IBM made these inconsistent actions and did not think through the consequences.

Speed was essential if IBM was to capture and hold a piece of this emerging market. Knowing this, IBM set a goal of getting from product design to market in 12 months.<sup>69</sup> As we have seen, one of the advantages of outsourcing is flexibility and speed. With this in mind, IBM departed from its strategy of internal development

and turned to Microsoft and Intel to develop the operating system and the microprocessor.<sup>70</sup>

Again, with speed in mind, IBM departed from another tenant of its strategy and implemented an open-architecture policy. The rationale was that this would enable many programmers to write applications for the IBM PC.<sup>71</sup> These two moves together meant that IBM would lose the competitive advantage it had sustained in the mainframe market. In the PC world, IBM could not offer the total package. Open architecture meant that other companies could offer IBM compatible PCs and with the two key components (the operating system and the microprocessor) available on the open market, significant barriers to entry were removed. The result was that after IBM entered the market, it was quickly followed by companies like Compaq and Dell. Absent a competitive advantage, IBM would not obtain the dominance it enjoyed in its mainframe market.<sup>72</sup>

Now let's examine these events within a strategic framework. IBM's vision was to enter and stake out a position in the desktop computer market. This was an emerging and lucrative market and one that threatened the dominance of its mainframes. In Wayne Gretzky's parlance, this was where the puck was going. IBM would not make the same mistake the integrated steel mills made. The next step is to craft a strategy that will position the firm so it can create and capture value. Unfortunately, with speed in mind, IBM went right from the vision to a business structure that would attain that vision. Had the company taken the time to think through strategy, things may have turned out differently.

To that date, IBM's competitive advantage had been the integrated package it offered. With speed-to-market the key, the company could not afford the time necessary to develop its PC in house. To dominate in the desktop computer

market, IBM would now need a new advantage. Recall that creating and capturing value is essential to gaining an advantage but that players, by entering the game, change the structure of the game. Taking into account that open architecture and outsourcing were going to change the competitive landscape, IBM could have attained an advantage in this emerging market by considering a simple question articulated by the Roman Statesman Cicero over 2,000 years ago: *Cui bono?* (Who stands to gain?)<sup>73</sup>

Open architecture meant that it would be relatively easy to assemble an IBM-compatible computer with the requisite ingredients. Of these, the operating system and the micro-processor would take on added value because they were proprietary to the two outsourcing partners. Microsoft and Intel would be the beneficiaries of this strategy.

With this in mind, IBM could have demanded equity stakes in both companies and both would likely have accepted. At this time, IBM was in a strong bargaining position. To Microsoft and Intel, IBM represented a vehicle that was capable of taking on Apple and getting their products to market. For its part, IBM had the requisite capital to take a strong position in both companies. It might have used this position as leverage to further shape the market to its advantage or, at the very least, it could have reaped the value Microsoft and Intel derived from this new business structure.<sup>74</sup>

By not addressing the strategic consequences, outsourcing worked to the detriment of IBM in the desktop computer market. This is not to say that outsourcing was a bad move on IBM's part. To enter the market at such a late date,

speed was essential. Outsourcing offered that speed and flexibility. The pertinent lesson is that outsourcing absent a coherent strategy can be a recipe for probable disappointment or potential disaster. IBM modified its strategic structure but did not modify its strategy. The result was that by the end of the 80s, micro-computers were eclipsing mainframes, Microsoft and Intel were rising to dominance and IBM was experiencing record losses.<sup>75</sup>

### Summary

We began this chapter with the premise that a firm can be effective across only a limited range of activities in the value chain. Knowing this, successful firms position themselves where they can best create and capture value. To this end, the firm seeks to develop an effective strategy that will provide it with a competitive advantage within the position it has chosen. We then demonstrated that strategy determines how the business will define itself and how it will subsequently structure itself.

In the next chapter, we examine DoD's strategic framework and its business strategy, both explicit and implicit. Specific emphasis is given to the Department's focus on efficiency and the employment of A-76 as an outsourcing tool.

At this juncture, the reader may be tempted to discount the value of any comparison between DoD and the private sector, but in fact the comparison is quite illuminating. Additionally, one may also be tempted to assume that industry will come out ahead in any comparison. However, there are areas where the private sector pales in comparison to DoD. We encourage you to read on.

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# 4

## THE DEPARTMENT OF DEFENSE'S BUSINESS STRATEGY AND COMPETITIVE SOURCING PROGRAM

*"If you don't know where you are going,  
any path will take you there."*

— Chinese Proverb

### Introduction

Up to this point, our discussion on strategy alignment has focused on the industry perspective. This chapter starts the discussion of corporate strategy from the Department of Defense (DoD) perspective. As the Department executes its Revolution in Business Affairs (RBA), it can use industry's lessons learned as a model to gain valuable insights. Benchmarking to successful companies helps set the standards required to make DoD more business-like. The purpose of this chapter is to develop the crosswalk from the Department's overarching corporate strategy to specific areas of execution. The chapter traces the development of the

competitive sourcing policies from DoD's overall corporate strategy. The analysis covers the alignment of DoD's strategy in terms of overall effectiveness and then narrows the scope to the efficiency of the current state of DoD's Competitive Sourcing program.

The analysis of the competitive sourcing program takes on an added significance as DoD transforms itself into a more business-like entity while coping with internal downsizing. In a March 12, 2001 report to Congress, DoD reported that it hires the equivalent of about 734,000 employees annually to perform service work. For the first time, this number exceeds the total number of civilian DoD federal

employees, which today stands at about 640,000.<sup>1</sup> For this reason alone, it is important to determine whether DoD is using the competitive sourcing program not only *effectively* but also *efficiently*. The chapter begins with DoD's corporate strategy, the Department's goals and objectives to support the strategy, and the alignment of the competitive sourcing program to support the strategy. The second part of this chapter focuses on the competitive sourcing processes and a review of the results to date. The chapter closes with a discussion of recent trends and recommendations.

### Strategy Development

Just as large corporations develop corporate-level strategies to support their overall objectives, DoD develops its strategy along a similar line. The Department established the corporate goals to support the objectives set forth in the 1997 Quadrennial Defense Review (QDR). Congress mandated the QDR requirement in the Military Force Structure Review Act, which was part of the Fiscal Year (FY) 1997 National Defense Authorization Act. The purpose of the 1997 QDR was to require DoD to conduct a comprehensive examination of America's defense needs from 1997 to 2015. The QDR lays the framework for the Department's strategic plan. This plan remains in effect until revived by the next QDR. The QDR includes an analysis of potential threats, strategy, force structure, readiness, modernization, infrastructure, and other parts of the defense program.<sup>2</sup> The intent of the QDR is to provide the parameters to develop a comprehensive defense program based on striking a balance between strategy and affordability. The Defense Department uses the annual Planning, Programming, and Budgeting System to implement the results of the QDR.

Congress requires DoD to conduct the QDR every four years. The next QDR is under way

during FY 2001 and will provide, with many other studies directed by Secretary of Defense Donald H. Rumsfeld, a re-look and recommendations to shape the armed forces at the dawn of the 21st century. These reviews are necessary to ensure the applicability of the defense strategy in an ever-changing world. Threats change over time. In order to adapt, DoD must take into account increasingly serious threats at home and abroad. Combating threats from rogue nations or terrorist groups armed with weapons of mass destruction or cyberhackers bent on destroying critical information networks requires a different approach from the old Cold War strategy. Now is the time for real transformational efforts.

The 2001 QDR will mark the fifth strategic review since the end of the Cold War. The others were the 1991 Base Force Review, the 1993 Bottom-Up Review, the 1995 Commission on Roles and Missions of the Armed Forces, and the 1997 QDR. Despite these well-intentioned efforts, the Department has not changed enough. There is a resistance to change especially when asked to change from what was a successful formula. What has been successful in the past, though, is not necessarily what will bring about continued success. Just like a business, DoD must seize the opportunity for change and adapt to ensure success in the future. Deputy Defense Secretary Paul Wolfowitz, a major contributor to the first Base Force Review for President George H. W. Bush, recently described the plan as, "...a giant step toward building a post-Cold War force." However, Wolfowitz understood the lack of strategic analysis by saying, "But it was largely a downsizing of the force. We didn't have a lot of time to think about the new shape of the force. We hadn't thought a lot about the new threats."<sup>3</sup> Although the world has changed dramatically over the past ten years, not much has changed in DoD's overall strategy and the way it conducts business. For example, Andrew

Krepinevich, director of the Center for Strategic and Budgetary Assessments, recently stated,

We really haven't had a good strategic review since the end of the Cold War, and the result is that our force today is smaller, but very similar to our Cold War force....The key will be whether the new strategy (produced by QDR 2001) reduces the risk we face from future threats, and whether or not there are sufficient resources identified to execute that strategy.<sup>4</sup>

The development of a strategy to achieve the organization's goals with supporting objectives is crucial for an organization's success. As in the previous discussion of effectiveness versus efficiency, DoD must ensure it is first doing the *right things* and then do *things right*. Unfortunately, the emphasis has been on efficiency not effectiveness. DoD must ensure the entire organization focuses on the common vision and relentlessly pursues it.

### A Look at Alignment

The following portion of this chapter will use the Strategic Direction Model to examine the building and alignment of DoD's subordinate goals and objectives to its overall strategy. The purpose of this examination will be to determine how competitive sourcing links back to support DoD's overall mission. The Defense Systems Management College (DSMC) uses the Strategic Direction Model as part of the curriculum to instruct students on strategy

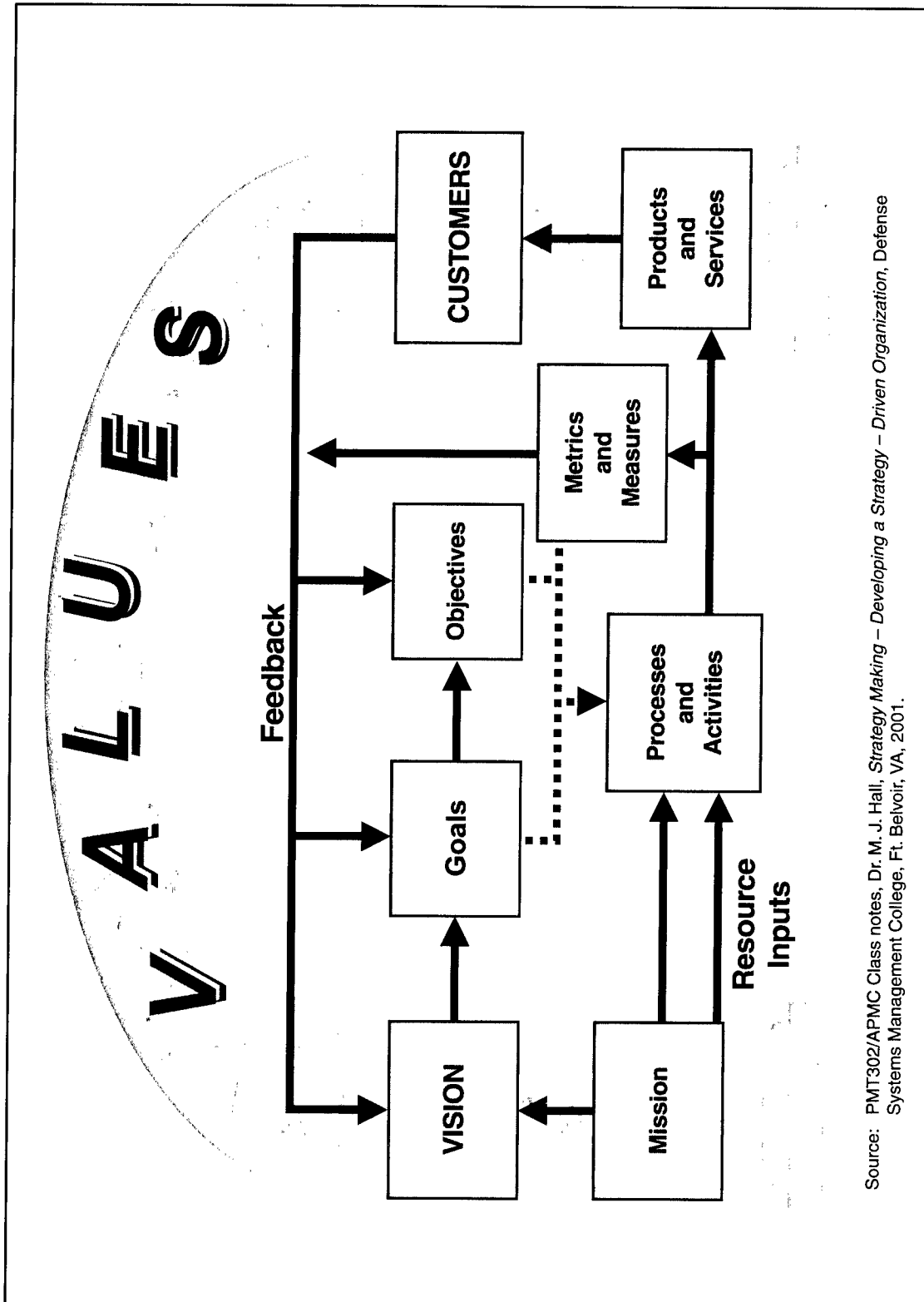
development. The students are predominately DoD employees with a small mixture of other governmental agency and defense contractor employees.

The Strategic Direction Model provides a holistic view of the organization's mission, vision, values, goals, objectives, processes, actions, activities, procedures, and operations used to satisfy customer requirements. The purpose of the model is to align the entire organization within certain boundaries. The intent is to ensure the organization knows where it is going using the right path. As the quotation at the beginning of the chapter states, "If you don't know where you are going, any path will take you there." Starting with the customer requirements, the model forces the organization to answer the basic questions, *Who are we?* *Why are we?* and *Where are we going?* through the mission and vision statements. The goals, objectives and control measures answer the questions, *How will we get there?* and *When will we know we are there?* Finally, the organization's values describe *What drives us?* Figure 4-1 shows the Strategic Direction Model.<sup>6</sup>

The Secretary of Defense's *2001 Annual Defense Report to the Congress and the President* (ADR) provides an annual report on DoD's strategy, supporting goals, and objectives, and how well they were met. The National Security Strategy, and in turn the National Military Strategy delineate a set of fundamental objectives that the ADR builds upon. Figure 4-2 shows these fundamental objectives.

**Each dollar that is spent inefficiently is a dollar that is unavailable to meet other internal Department priorities such as weapon system modernization and readiness.**

**GAO, GAO-01-244 DoD Challenges<sup>5</sup>**



Source: PMT302/APMC Class notes, Dr. M. J. Hall, Strategy Making – Developing a Strategy – Driven Organization, Defense Systems Management College, Ft. Belvoir, VA, 2001.

Figure 4-1. Strategic Direction Model

***Since the founding of the Republic, the United States has embraced the fundamental and enduring goals of maintaining the sovereignty, political freedom, and independence of the United States, with its values, institutions, and territory intact; protecting the lives and personal safety of Americans, both at home and abroad; and providing for the well-being and prosperity of the nation and its people.***

**Chapter 1, 2001 Annual Defense Report**

Source: William S. Cohen, Secretary of Defense, Annual Report to the President and the Congress, Chapter 1, 2001, retrieved 12 March 2001 from the World Wide Web: <http://www.dtic.mil/execsec/adr2001/chapter01.pdf>.

**Figure 4-2. 2001 ADR Fundamental Objectives**

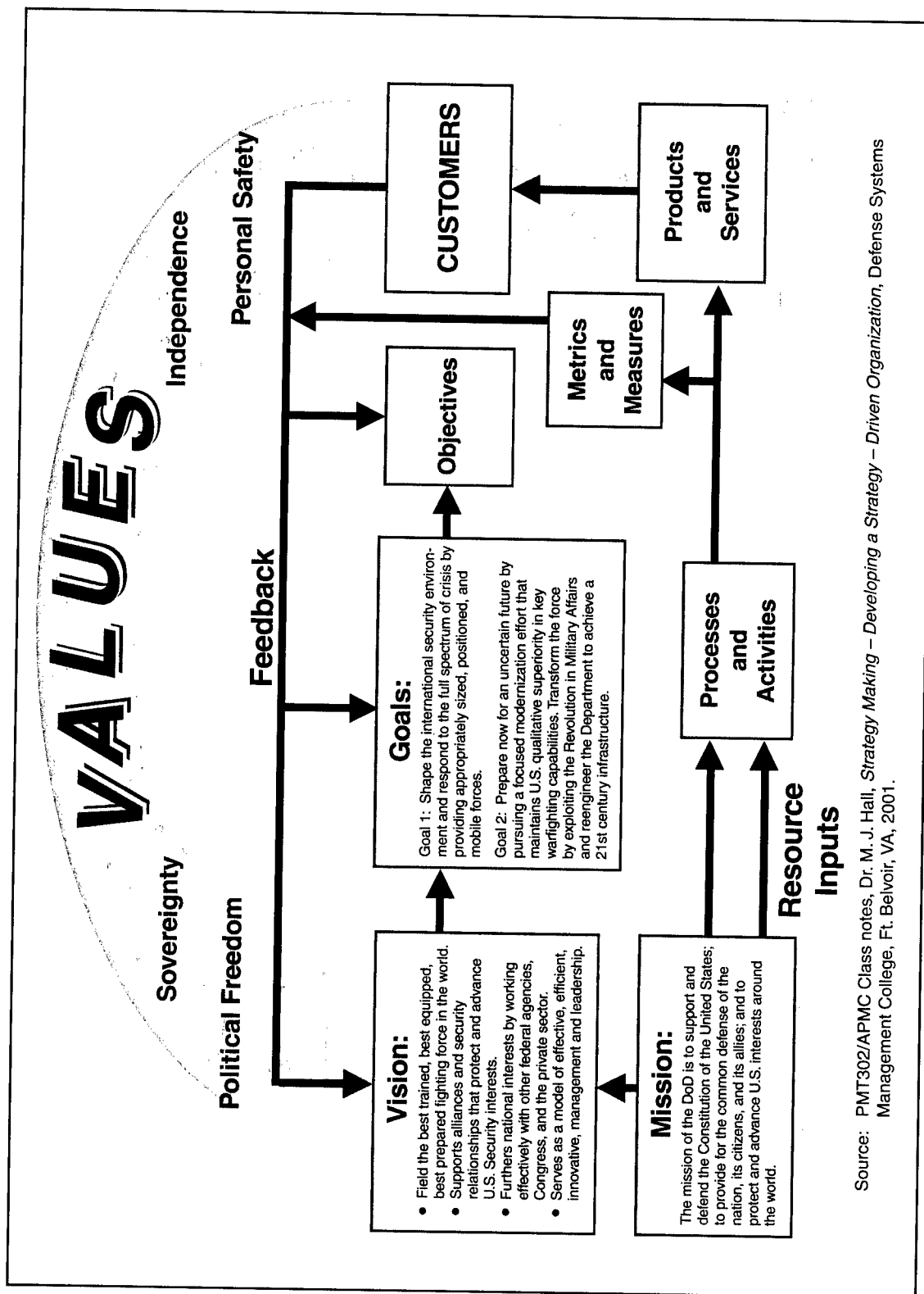
Similar to a corporation's focus on customer requirements, DoD's customer requirements are in terms of sovereignty, political freedom, and independence. It is from this linkage, from the fundamental objectives above through the National Security Strategy to the National Military Strategy, that DoD develops its mission, strategic vision, and corporate goals.

The ADR clearly lays out the mission, vision and corporate-level goals for DoD. The mission statement answers the fundamental questions of *Who are we?* and *Why are we?* The mission statement defines the basic purpose of the organization, focusing on its core programs and activities. The 2001 ADR states the mission as, "To support and defend the Constitution of the United States; to provide for the common defense of the nation, its citizens, and its allies; and to protect and advance U.S. interests around the world."<sup>7</sup>

From the mission the next question to answer is *Where are we going?* The vision statement contains this answer. In their book, *The New Strategists: Creating Leaders at All Levels*, Stephen J. Wall and Shannon R. Wall describe the vision as a "...portrait of future success."<sup>8</sup>

In support of the mission, DoD's vision has four tenets. First, field the best trained, best equipped, best prepared fighting force in the world. Second, support alliances and security relationships that protect and advance U.S. security interests. Third, further national interests by working effectively with other federal agencies, Congress, and the private sector. Fourth, serve as a model of effective, efficient, innovative management and leadership.

Once we understand the purpose and the direction to go, the next step in the process is to answer the question, *How will we get there?* Using the mission and vision as guiding principles, DoD established two corporate-level goals to answer this. The first goal is to shape the international security environment and respond to the full spectrum of crises by providing appropriately sized, positioned, and mobile forces. The second goal is to prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities and transforms the force by exploiting the Revolution in Military Affairs (RMA) and reengineer the Department to achieve a 21st century infrastructure. Focusing on these goals



Source: PMT302/APMC Class notes, Dr. M. J. Hall, *Strategy Making – Developing a Strategy – Driven Organization, Defense Systems Management College, Ft. Belvoir, VA, 2001.*

Figure 4-3. Strategic Direction Model

ensures DoD continues to move in the right direction on the way to achieving the vision.

Using the inputs from the 2001 ADR, the Strategic Direction Model from Figure 4-1 is now shown in Figure 4-3.

DoD develops a set of objectives to enable the organization to achieve the corporate-level goals developed through the QDR. The objectives are measurable, specific actions. The ADR calls these objectives annual performance goals. For example, the 2001 ADR states, "The Department's annual performance plan plots a short-term course toward achieving its multiyear strategic plan. Annual performance goals (objectives according to the model) establish a measurable path to incremental achievement of the corporate goals articulated in the strategic plan. Performance goals are

supported and evaluated by quantifiable output, which is assessed using performance measures and indicators."<sup>9</sup> Figure 4-4 shows the corporate goals with associated objectives.

In order to ensure that day-to-day activities of the organization continue to support the strategic goals of the organization, performance measures and metrics must be put in place. In 1993, Congress enacted the Government Performance and Results Act (GPRA) because in their view, federal agencies were focused on outputs rather than on outcomes.<sup>10</sup> The purpose of the Act is to hold agencies accountable to achieve specific results and operate in a more business-like fashion. The GPRA seeks to improve government-wide program effectiveness, government accountability, and public confidence by requiring agencies to identify measurable annual performance goals against

Corporate Goal 1: Shape and Respond	Corporate Goal 2: Prepare
<ul style="list-style-type: none"> <li>• 1.1 Support U.S. regional security alliances through military-to-military contacts and the routine presence of ready forces overseas, maintained at force levels determined by the QDR.</li> <li>• 1.2 Maintain ready forces and ensure they have the training necessary to provide the United States with the ability to shape the international security environment and respond to a full spectrum of crises.</li> <li>• 1.3 Maintain the capability to move military forces from the United States to any location in the world in response to aggression, using a combination of airlift, sealift, and prepositioned equipment.</li> </ul>	<ul style="list-style-type: none"> <li>• 2.1 Recruit, retain, and develop personnel to maintain a highly skilled and motivated force capable of meeting tomorrow's challenges.</li> <li>• 2.2 Transform U.S. military forces for the future.</li> <li>• 2.3 Streamline the DoD infrastructure by redesigning the Department's support structure and pursuing business practice reforms.</li> <li>• 2.4 Meet combat forces' needs smarter and faster, with products and services that work better and cost less, by improving the efficiency of DoD's acquisition processes.</li> <li>• 2.5 Improve DoD financial and information management (new goal for FY 2001).</li> </ul>

**Figure 4-4. Linkage of Corporate Goals to Annual Performance Goals**



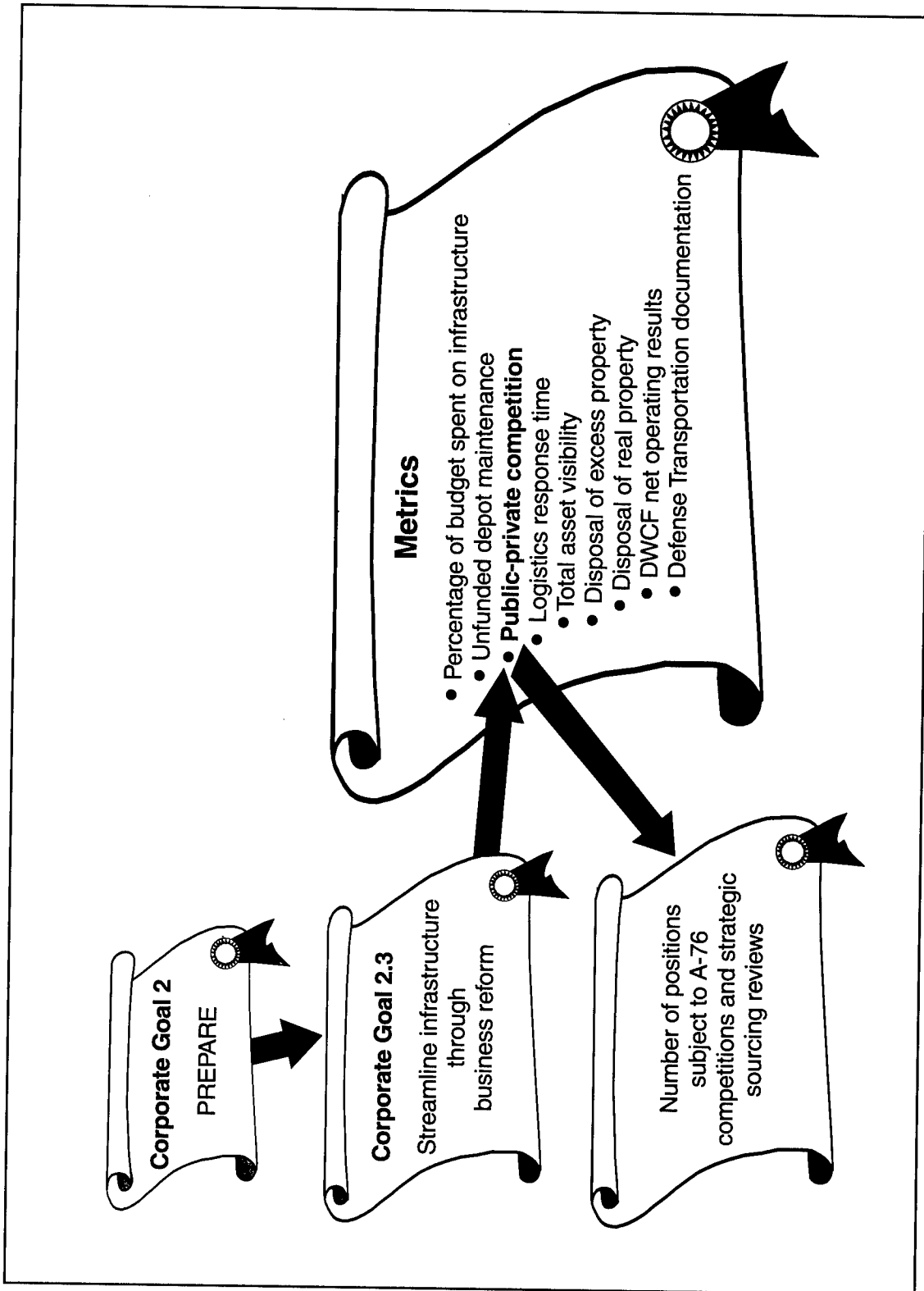


Figure 4-5. Linking Corporate Goals to Performance Measures

which actual achievements can be compared. The intent is to ensure that there is a link from the day-to-day activities of the agency to its long-term strategic goals. The complementary nature of the strategic plans and the annual plans form the basis for DoD to "manage for results."<sup>11</sup> The report becomes an annex to the ADR (albeit published separately). The GPRA consists of two parts: the performance goals for the upcoming year consisting of performance targets and metrics, and a "Report Card" that assesses how well DoD achieved the performance goals during the preceding year. For example, the 2001 report will assess how well DoD met its FY 2000 performance goals and identify future performance goals for FY 2002. The Department submits the report to Congress annually.

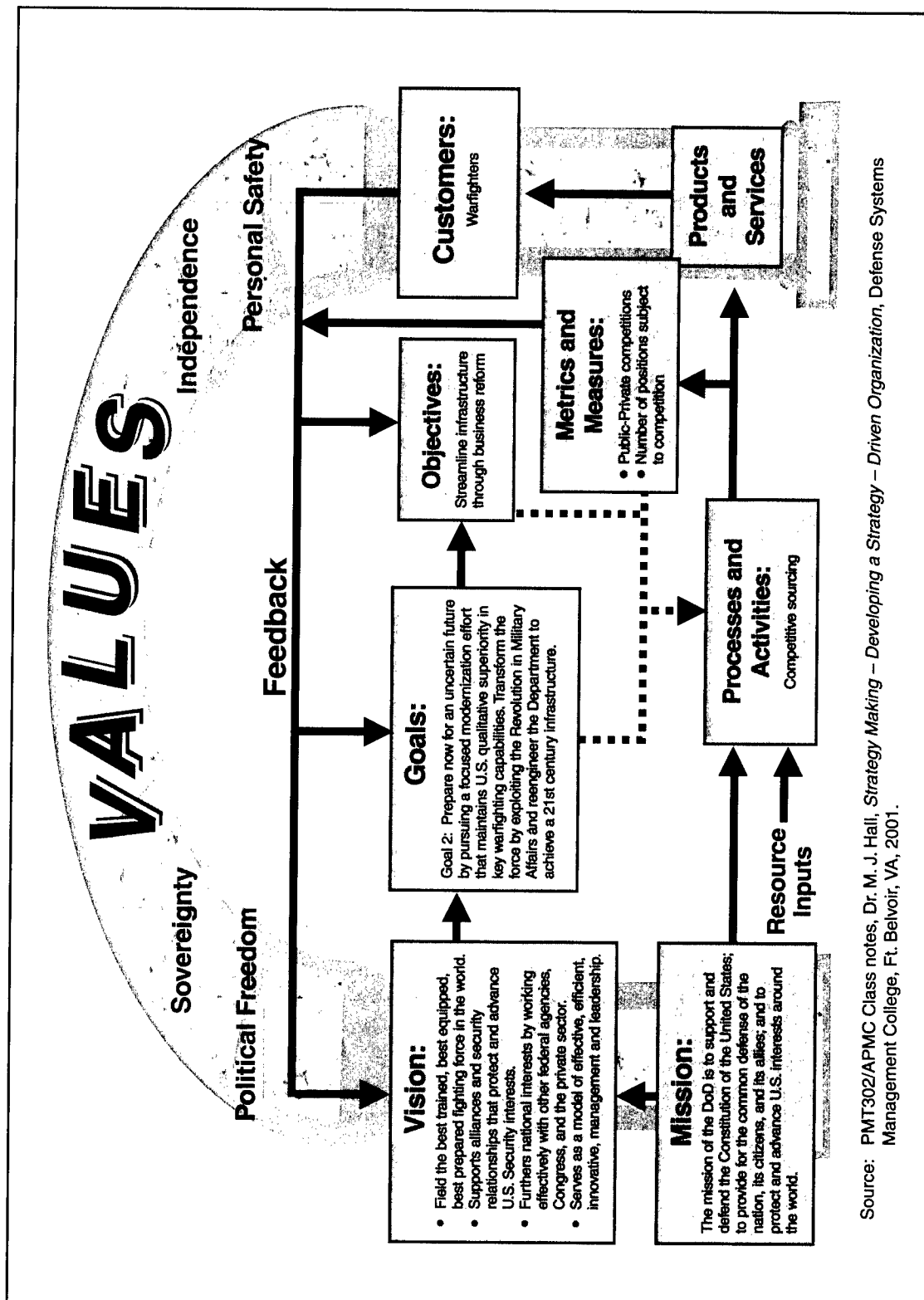
Each one of the eight performance goals listed in Figure 4-4 contains several performance measures and indicators. For example from Figure 4-4, the corporate goal, *Prepare* has five lower level performance objectives. Each of the objectives is further broken down into performance measures. Figure 4-5 shows this relationship. From DoD's corporate goal, *Prepare*, the competitive sourcing strategy falls under the performance objective, Streamline Infrastructure through Business Reform. This performance objective further breaks down into nine metrics: Percent of Budget Spent on Infrastructure, Unfunded Depot Maintenance, Public-Private Competition, Logistics Response Time, Total Asset Visibility, Disposal of Excess Property, Disposal of Real Property, Defense Working Capital Fund, Net Operating Results, and Defense Transportation Documentation.

The next phase is to ensure that the measurement control system is in place to provide the necessary feedback of the performance results and how these results support the overall strategy. It is best if these performance

measures are as quantifiable as possible; however, in large complex organizations such as DoD, some qualitative measures are sometimes unavoidable. In the annual performance plan, DoD assesses the performance indicators on two levels. The first level is how well the individual performance indicator met its own numeric targets at the end of the year. For example, did DoD meet its goal for the number of positions subject to the Office of Management and Budget (OMB) Circular A-76 (A-76) Competitions or Strategic Sourcing reviews? The second level is how well the performance indicator supports the performance measure of Public-Private Competition. Finally, a subjective determination is made on the achievement of the corporate goal if one of the metrics or the interaction of a set of metrics are not met. In this example, one would ask if we are focusing on the right performance measures to achieve our desired outcome of streamlining infrastructure through business reform.

Figure 4-6 shows a streamlined version of the Strategic Direction Model that focuses on the Competitive Sourcing process.

In a recent General Accounting Office (GAO) Report, *Major Management Challenges and Program Risks*, while GAO acknowledged DoD's improved strategic planning process, it also pointed out that DoD's strategic plan was still not tied to desired mission outcomes. The report further states that inefficiencies in the planning process have led to difficulties in assessing performance in the areas of combat readiness, support infrastructure reduction, force structure needs, and the matching of resources to program spending plans. The report recommended that DoD include more qualitative and quantitative goals and measures in its annual performance plan and report to assess the progress toward achieving the desired mission outcomes.



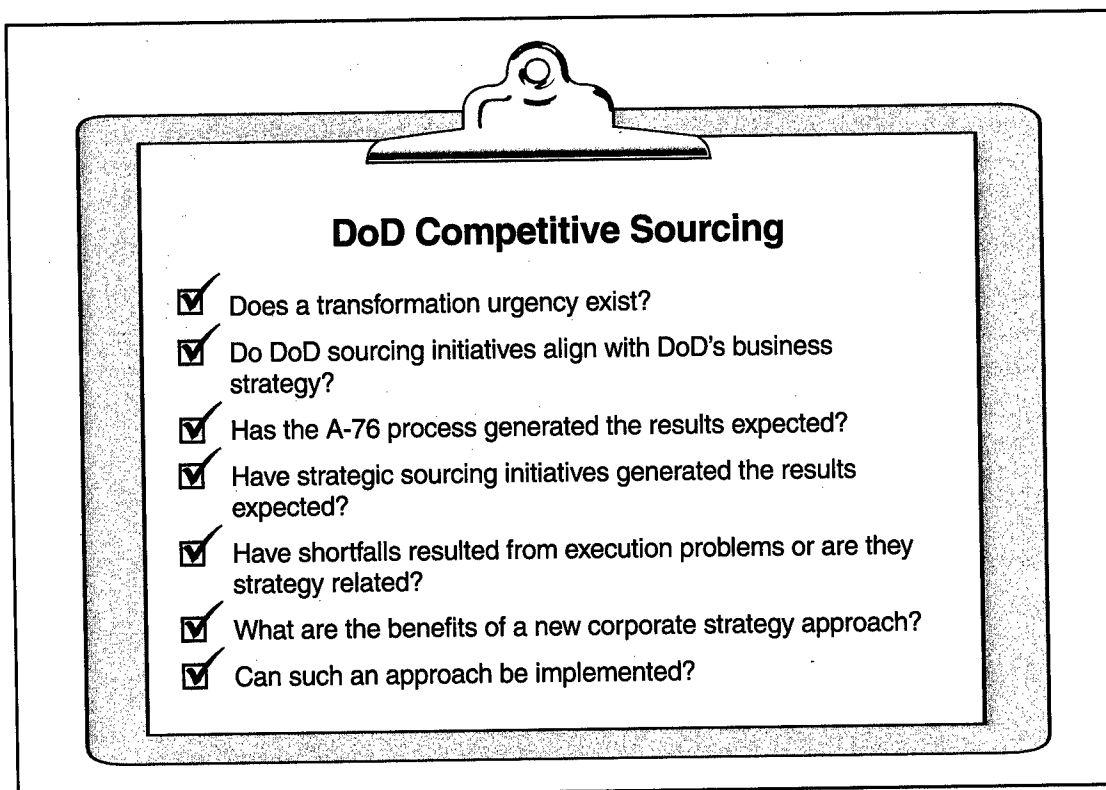
Source: PMT302/APMC Class notes, Dr. M. J. Hall, *Strategy Making – Developing a Strategy – Driven Organization, Defense Systems* Management College, Ft. Belvoir, VA, 2001.

Figure 4-6. Tracing Competitive Sourcing Through the Strategic Direction Model

The example above tracing the linkage from the mission to the A-76 studies is a good example of the problem noted by GAO. Under the metric, Public-Private Competition, there is only one performance measure: number of positions subject to A-76 competitions or strategic sourcing reviews. One cannot get a true perspective on DoD's Public-Private Competitions just by looking at number of positions competed. Focusing on positions alone leaves out the important aspect of *why* DoD is competing *those* positions. Additionally, reporting solely on one performance measure misses a holistic outlook to answer such questions as the following in Figure 4-7.

As will be shown below, these are important questions. DoD now lists more than 450,000 civilian positions that could be performed by the private sector.<sup>12</sup> The number of employees

in addition to the amount of DoD budget tied to support functions, overhead, and infrastructure (estimates being about 60 percent or \$180 billion) makes this significant. If DoD were to spin off a stand-alone company of 450,000 employees with a budget of \$180 billion, it would rank between second and third on the Fortune 500 list, between Wal-Mart and General Motors (GM). According to Table I-1 in the Introduction, the spin-off would have about the same operating expense as GM, while having more than four times the number of employees. The sheer size of this portion of DoD's budget alone makes it imperative that leaders ensure the Department receives the best value for the resources committed. The following sections of this chapter will discuss DoD's competitive sourcing programs with follow-on recommendations.



**DoD Competitive Sourcing**

- ☒ Does a transformation urgency exist?
- ☒ Do DoD sourcing initiatives align with DoD's business strategy?
- ☒ Has the A-76 process generated the results expected?
- ☒ Have strategic sourcing initiatives generated the results expected?
- ☒ Have shortfalls resulted from execution problems or are they strategy related?
- ☒ What are the benefits of a new corporate strategy approach?
- ☒ Can such an approach be implemented?

**Figure 4-7. Competitive Sourcing Questions**

## Historical Background of DoD Sourcing

Since the American Revolution, America has relied on a partnership with industry to supply essential goods and services as part of the defensive strategy. The relatively nonexistent government infrastructure during the Revolutionary War forced the Continental Congress to leverage commercial industry to support the fledgling army. Congress relied on the experience and knowledge of colonial merchants to develop supply procedures. Whether directed by congressional committee or supply officers, merchants handled procurement functions. The merchant directed his own business or entered into a partnership with another. For example, the firm of Otis and Andrews actively supplied clothing while Willing and Morris supplied gun powder to the Continental Army.<sup>13</sup> The reliance on the competitive forces of the marketplace has not changed.

The need for sound competitive sourcing strategies is just as important today. The reasons why organizations opt for sourcing solutions have not varied significantly since that time period. Our research has shown DoD organizations generally turn towards outsourcing for several reasons:

- Improve performance, quality, efficiency and cost reductions through competition;
- Focus existing personnel and resources on core activities;
- Sustain readiness;
- Generate savings for modernization.

Since the end of the Gulf War, DoD active military strength has been reduced by over 700,000 people. As stated in Chapter One, this translates into the elimination of eight Army Divisions, eleven Air Force Fighter Wings, four

Navy aircraft carriers and 232 other ships.<sup>14</sup> Despite the reductions to the combat forces, support cost have climbed to nearly \$200 billion a year and now consume nearly 70 cents of every defense dollar, compared to 50 cents before the drawdown.<sup>15</sup> To compound this situation, DoD has been involved in more than 50 contingency operations during this same time period.<sup>16</sup> The high tempo of operations combined with reduced material and financial resources required DoD to re-think the way it conducts business. In order to implement the new strategies coming out of the QDR, the Department had to change the way it conducted business because the old way no longer worked. Then Secretary of Defense William Cohen instituted the DRI to address the third point of the Department's corporate vision statement, which was to conduct an RBA. The purpose of the RBA is to garner the best commercial techniques and procedures and use them to revitalize DoD's acquisition process. The success of the RBA is crucial to enable the reallocation of funds to meet the needs of the warfighter.

## Defense Reform Initiative

In November 1997, then Secretary of Defense William Cohen initiated the Defense Reform Initiative (DRI) to move DoD into the 21st century. The purpose of the DRI was to provide a strategic blueprint to revolutionize business affairs within the Department by incorporating lessons learned from private industry. The DRI addressed the third element of DoD's corporate vision: to further national interests by working effectively with other federal agencies, Congress and the private sector.<sup>17</sup> The initiative was necessary to support the new defense strategy developed during the 1997 QDR. In order to execute the new strategy — *Shape, Respond, and Prepare* — DoD required a balance of resources between meeting existing global requirements and ensuring investment for the future. The DRI initiatives sought to

improve DoD's old business practices in order to free and reallocate resources currently tied up in overhead and support activities. Initially, the DRI consisted of a series of initiatives in four areas:

- **Reengineer:** Adopt modern business practices to achieve world-class standards of performance.
- **Consolidate:** Streamline organizations to remove redundancy and maximize synergy.
- **Compete:** Apply market mechanisms to improve quality, reduce costs, and respond to customer needs.
- **Eliminate:** Reduce excess support structures to free resources and focus on core competencies.

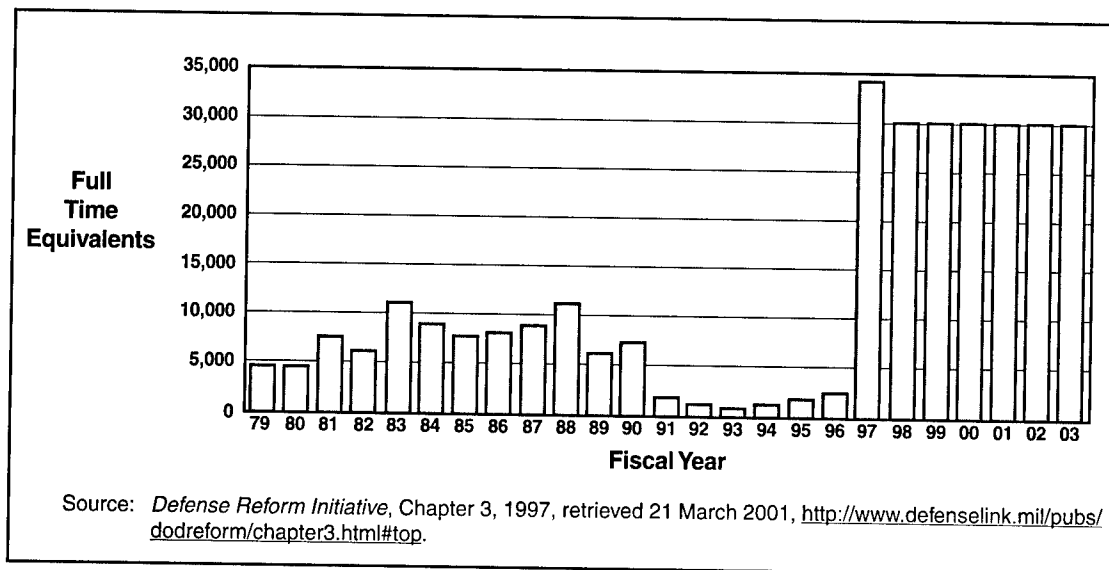
While the scope of the DRI has broadened over time, the competitive sourcing program has endured as a critical enabler for defense reform. As part of the DRI, the Department announced a goal to conduct A-76 competitions involving 30,000 Full Time Equivalents (FTEs) per year through FY 2003 for a total of 150,000 FTEs.<sup>18</sup> This was a significant increase to the number of FTE functions that had been competed annually up to that point. Full Time Equivalent is a standardized term that represents one work year enabling the government to use similar units for comparisons. For example, during the 18-year span from 1979 through 1996, DoD competed "only" just over 90,000 FTE

functions. In fact until 1997, 1983 represented the one-year historical high point in which DoD competed a little over 10,000 FTEs. Historically half of the competitions were won by the private sector while the rest remained government in-house; the combined average savings was 31 percent. However, according to the 1999 Defense Reform Initiative Directive (DRID) 20 Report, closer examination showed that when the private sector won, operating costs dropped by 38 percent whereas when the government in-house team won, the operating costs reduced by an average of 19 percent.<sup>19</sup> Now DoD intends to vastly escalate the number of public-private competitions in a quest to realize additional savings. Figure 4-8 taken from the DRI 1997 report clearly shows the magnitude of change and the major undertaking confronting DoD.

A second result of the DRI was a budget action in response to the anticipated savings from the competitions. Today DoD anticipates cumulative savings to be \$11.7 billion through FY 2005 and then \$3.5 billion annually thereafter.<sup>21</sup> These numbers include the cumulative results of planned A-76 and strategic sourcing initiatives from FYs 1997 through 2005. Through A-76, DoD expects to study about 203,000 positions, and achieve \$9.2 billion in savings and \$2.8 billion in annual recurring savings after 2005. Through the strategic sourcing program, DoD expects to study an additional 42,000 positions, achieve \$2.5 billion in savings with an additional \$0.7 billion in recurring savings after 2005.<sup>22</sup>

**This is not a short term effort (DRI) simply to save money; but rather a long term transformation that fundamentally reorients mindsets throughout the department.**

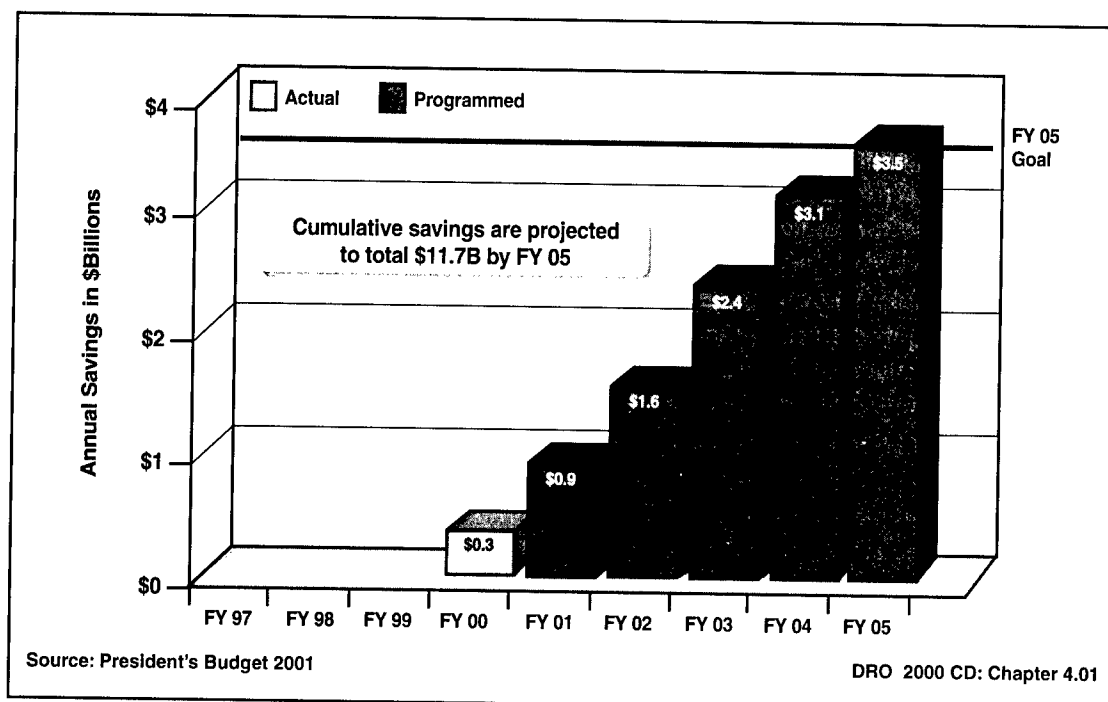
**(Then) Secretary of Defense Cohen  
February 25, 2000<sup>20</sup>**



**Figure 4-8. Comparing DRI Objectives (1997-2003) to the Historical Annual Number of FTE Positions Completed**

An important aspect of the implementation of the DRI was that the anticipated savings were taken out of the budget immediately up front without proof that the savings would actually

occur. This action has placed severe pressure on the program to live up to its expectations. Figure 4-9, taken from a CD-ROM published by DoD, entitled *DRI Checkpoint 2000: On the*



**Figure 4-9. Projected DoD Savings through Competitive and Strategic Sourcing**

*Road to Excellence*, shows the steep savings ramp DoD must climb in order to meet its expectations. Questions must be, Are the processes in place? and Do the personnel conducting the competitions have the training and incentives required to execute the competitions to realize the expected savings DoD is expecting? The following paragraphs will examine these fundamental questions.

### DRI Directive 20 Report

In order to improve the identification of the commercial activities for the A-76 competitions, then Deputy Secretary of Defense, Dr. John J. Hamre, signed *Defense Reform Initiative Directive #20: Review of Inherently Governmental Functions*, on January 16, 1998. Dr. Hamre directed the development of uniform guidelines, criteria, and reason codes for DoD components to determine which functions and positions are inherently governmental in nature, commercial activities exempt from A-76 competition, and commercial activities that should be competed.<sup>23</sup> The DRID 20 requirements provided a means to monitor the progress of the

Services in the implementation of the sourcing goals established during the DRI. The Office of Federal Procurement Policy, Policy Letter 92-1, defines inherently governmental functions as those activities that “require either the exercise of discretion in applying governmental authority or the use of value judgments in making decisions on behalf of DoD.”<sup>24</sup> Commercial activities that are exempt from competition are those functions relating to national security concerns or legislative prohibition (depot maintenance, firefighters, security guards). The third category contains those functions that should be competed. The Department published the results of the inventory in December 1999. The results included an analysis of over 2.95 million positions. These positions included 2.2 million military and over 740,000 government civilian positions. The results are shown graphically in Figure 4-10.

The results of the 2.95 million position inventory broke out as follows: DoD classified a total of 2,049,111 (69 percent) positions as inherently governmental; 618,506 (21 percent) positions as commercial exempt from competition; and

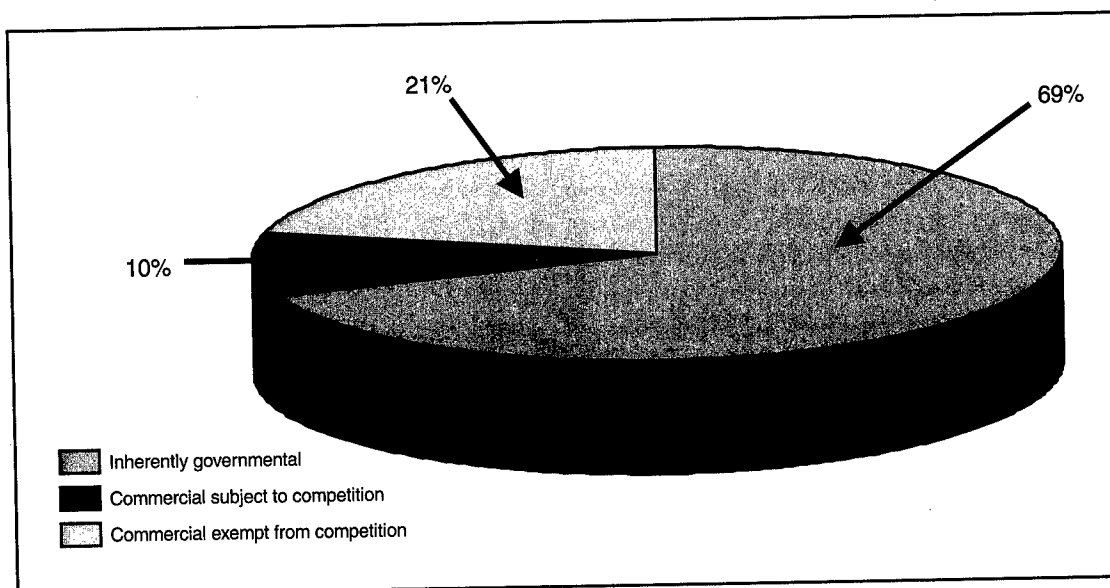


Figure 4-10. Results of the DRID 20 Inventory



283,000 (10 percent) positions as commercial subject to competition. Of those positions subject to competition, over 52,900 were military, with the remainder civilian.<sup>25</sup>

The DRID 20 report provided a comprehensive snapshot in time of the allocation of work functions across DoD and the identification of a potential pool of competitive sourcing candidates. In fact, the pool of candidates identified in the report exceeded the FY 1997 Commercial Activity Report by a total of 81,000 positions. However, it was also recognized that the total number would have to be increased to meet planned budget requirements.<sup>26</sup>

Additionally, DoD recognized several other shortcomings. Inconsistencies in the identification of workload mix and coding of positions existed among the Services. For example, in an August 2000 GAO report on competitive sourcing entitled *More Consistency Needed in Identifying Commercial Activities*, the GAO found the Army used a centralized approach that standardized coding across the Service. In contrast, the Navy and Air Force used a more decentralized approach that resulted in commands applying different codes to the same functions.<sup>27</sup>

The differences among the Services also led to inconsistencies in coding of positions. For example, the Army listed its public affairs activities at its military academy as commercial while the Navy listed its public affairs activities at Annapolis as inherently governmental.<sup>28</sup> The Department established integrated process teams to review the procedures and the teams still function today. The number of positions available for competition will change as DoD refines its core competencies as the new administration clarifies its strategic plan. The DRID 20 process provided the first step in an iterative process to identify those functions that were inherently governmental in

nature and those functions that were commercial activities. The following year Congress enacted the Federal Activities Inventory Reform (FAIR) Act. The DRID 20 report and methodology provided a foundation for DoD's future actions to meet FAIR Act requirements.

### **Federal Activities Inventory Reform Act**

On October 12, 1998, President Clinton signed the FAIR Act of 1998 (Public Law 105-270). The law requires all executive agencies to submit to Congress an annual list of activities that are not inherently governmental functions and, as such, are possible candidates for A-76 studies. The law defines inherently governmental functions as those functions so intimately related to the public interest as to require performance by government employees.<sup>29</sup> The significance of the FAIR Act is that although Congress required commercial inventories prior to enactment, now the results were made openly available and the public could challenge what was or was not on the list.

In 2000, DoD listed 452,807 positions that could be performed in the private sector. Of these positions, DoD listed only 178,771 as commercial subject to competition. Those activities identified as commercial subject to competition do not include any uniformed positions or depot maintenance work because the law does not require DoD to report those positions. Also, the law does not require agencies to competitively source any of the activities. However, the FAIR Act report does provide a starting point. According to Stan Soloway, president of the Professional Services Council and former Deputy Under Secretary of Defense for Acquisition Reform, "On some levels it isn't taken seriously enough." He went on to say the Act provides, "a base to discuss what the government should be doing. It's not an end in itself."<sup>30</sup>

The August 2000 GAO report on the consistency of DoD's identification of commercial activities concluded many of the inconsistencies in the DRID 20 report still held true for subsequent FAIR Act submissions. The report concluded:<sup>31</sup>

- Variations in how DoD components developed the inventories and lack of clear guidance on category activities that were not core activities may have limited the potential to identify additional commercial positions.
- Further inconsistencies in reporting procedures will persist without clear guidance on what activities are core commercial activities.
- Even if additional commercial functions are identified, the GAO did not expect DoD to significantly increase the number of functions under the A-76 process due to already aggressive competition goals.
- Factors such as the inability to group positions due to geographic dispersion or to separate commercial activities from inherently governmental work may limit the number of functions that can be studied.

The report recommended the Secretary of Defense increase the consistency in the identification of commercial activities by making top-level decisions on whether certain activities should be considered eligible for competition. To date, this work is still ongoing by DoD; however, there is no desire to determine a strict set of guidelines throughout DoD.

At the time of writing, as the new administration takes shape, the initial indications are that FAIR Act inventories in relation to A-76 competitions will grow in importance. On March 9, 2001, Sean O'Keefe, Deputy Director of OMB, published a memorandum outlining

performance goals and management initiatives for the FY 2002 budget. The memo directs agencies to complete public-private or direct conversion competitions on not less than 5 percent of the FTEs listed on their FAIR Act inventories. The 5 percent threshold includes the positions that DoD exempted from competition; for example the figure would represent over 22,640 of the 452,807 commercial positions on their FAIR Act list. The memo highlights the President's commitment to open at least one-half of the Federal positions listed on the FAIR Act inventory of commercial functions to competition with the private sector.

One area of concern with the recent OMB guidance is the use of direct conversions of positions. The A-76 Supplemental Handbook lists four instances when agencies can directly convert positions to the private sector without performing cost-comparison studies:<sup>32</sup>

- Agencies can convert a federal activity if it involves ten or fewer positions.
- If a function involves 11 or more positions, the agencies must place the reassigned federal employees to comparable federal positions for which they are qualified.
- Commercial activities of any size may be converted to contractors who qualify as preferential procurement sources under section 8(a) of the 1953 Small Business Act.
- Agencies may also apply for a waiver from the A-76 process to directly convert positions.

However, trying to achieve the OMB thresholds solely through direct conversions will be met with resistance. This method has naturally drawn strong opposition from the American Federation of Government Employees (AFGE). For example, Mr. Bobby Harnage, President

of the AFGE, recently stated before the Subcommittee on Readiness of the House Armed Services Committee in March 2001, “This direct conversion process is federal service contracting in its essence: a corporate welfare boondoggle.”<sup>33</sup> As DoD seeks to meet the OMB guidance, it must use a balance of direct conversions with competing functions through the A-76 process.

### **OMB Circular A-76**

The OMB Circular A-76, issued in 1966, establishes federal policy for the performance of commercial activities. The Circular defines a commercial activity as an activity that is operated by a federal executive agency and provides a product or service that could be obtained from a commercial source.<sup>34</sup> The policy recognizes the principle that the government should not be in competition with the commercial sector. As such, the general policy of the government is to rely on commercial sources to supply its products and services if the product or service can be procured more economically from a commercial source.

The Supplement to Circular A-76, first issued in 1979 and revised in March 1996, provides the guidelines to determine whether the commercial activities should be performed by DoD, the private sector, or another federal agency. The policy is based on the idea that competition enhances quality, economy, and productivity. The handbook provides guidance for managers to make sound and justifiable business decisions.<sup>35</sup> The basic purpose of an A-76 study is to determine the cost efficiency of retaining services provided by a government organization or contracting for those services with a commercial firm. The policy states that in accordance with the Circular and the Supplement, whenever commercial sector performance of a government-operated commercial activity is permissible, a comparison of the cost

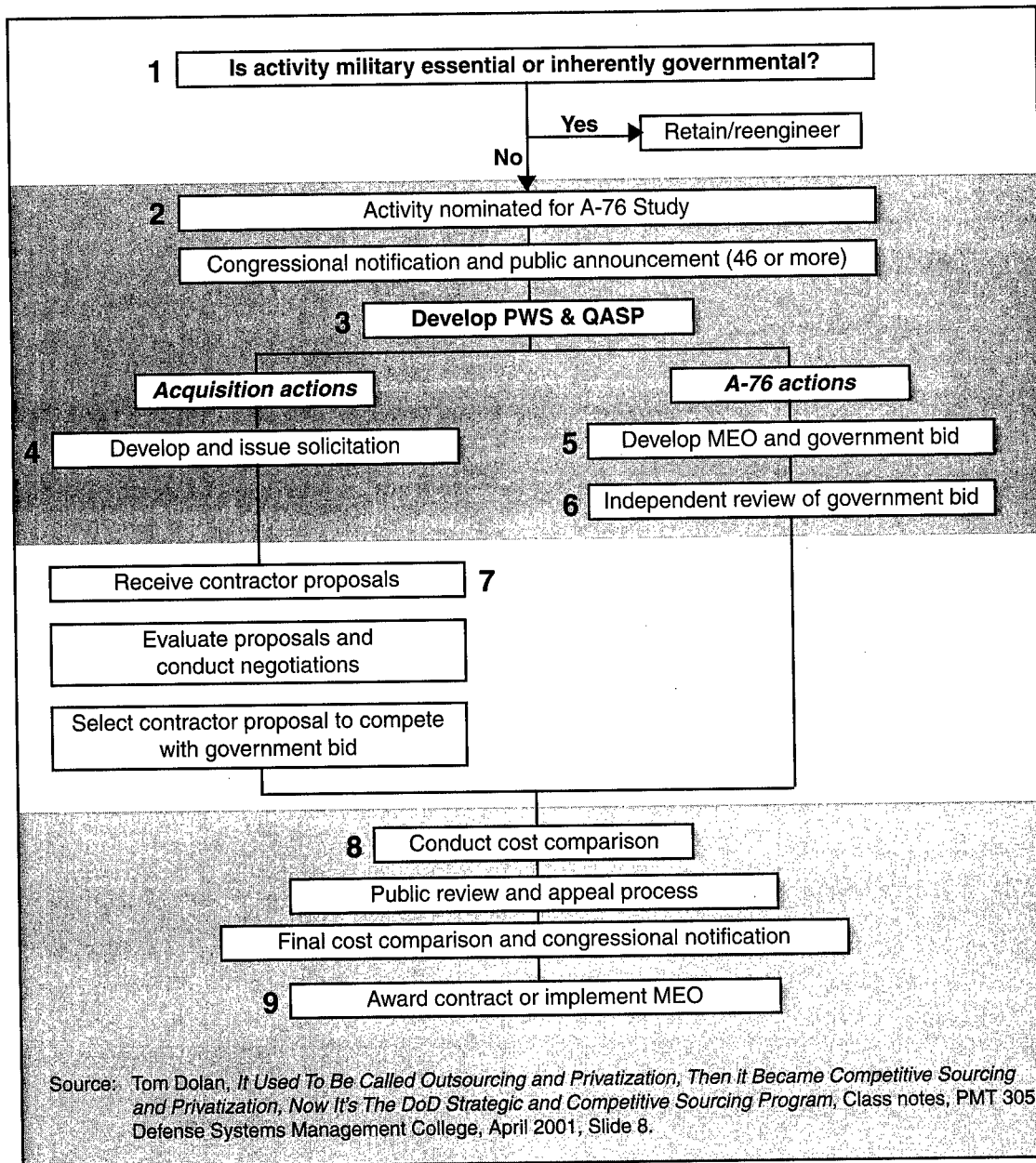
of contracting and the cost of in-house performance shall be performed to determine who will do the work.

As stated in the handbook, the A-76 policy is not designed to simply contract work out. However, the program is used to:<sup>36</sup>

- Balance the interests of the parties to a make-or-buy cost comparison;
- Provide a level playing field between public and private offerors to a competition;
- Encourage competition and choice in the management and performance of commercial activities.

On the surface the A-76 cost comparison process is very straightforward. An organization determines an activity to study, develops a work statement that describes what needs to be done, receives bids from the commercial sector, compares these with the in-house cost estimate, then selects the lowest-cost provider. However, in practice the A-76 process has proven a very controversial and challenging program. For example, due to inconsistencies in the selection process, the former Deputy Secretary of Defense mandated a review because of the controversy surrounding the Air Force’s awarding of service contracts at Lackland Air Force Base. The Service reversed its decision twice before DoD put a halt to the contract award and all other Air Force A-76 competitions pending review. Figure 4-11 shows an overview of the A-76 process and is followed by a discussion of the key activities according to the Supplemental Handbook.

Once an agency determines it will use the A-76 process and all notifications are complete, the first step is to write the Performance Work Statement (PWS) and the Quality Assurance Surveillance Plan (QASP). The PWS should



**Figure 4-11. A-76 Cost Comparison Process**

clearly define what is being requested, the performance standards and measures, and timeframes required. One important point of emphasis is that the PWS should articulate *what* work needs to be done, not *how* to accomplish it. The *how* is the essence of the offeror's proposal. The Handbook points out that special

care should be taken when developing the PWS to ensure it does not limit Service options, arbitrarily increase risk, reduce competition, unnecessarily violate industry service or service grouping norms, or omit statutory or regulatory requirements without full justification.<sup>37</sup> The importance of developing a complete PWS

is critical for the success of the future steps. The Inspector General of DoD reported that 70 percent of the increases in outsourced contracts are due to changes in the PWS.

The A-76 study team derives the QASP based on performance standards to adequately determine if the services rendered by whoever does the work meet the standards set in the PWS. Specific elements to be addressed by the QASP are the inspection methods used, the reports required, and the resources to be employed with estimated man-hours.

At this point a parallel effort can begin. First, the government team develops its management plan consisting of the most efficient organization (MEO), QASP, in-house cost estimate, and the transition plan. The MEO describes how the in-house government team will perform the work according to the PWS, as well as manpower, budget, and facility requirement. The QASP is developed as the MEO quality assurance plan. The in-house cost estimate shows how much it will cost the team to operate under the assumptions, as the MEO and the transition plan outline how the current organization will transition into the MEO in the proposal. While the government team is doing its part, the contracting officer issues the solicitation to the contractors for them to develop their proposals. The evaluation of the proposals occurs with the selection of one contractor. At this point in the selection process there is one contractor team and the government's MEO.

During the evaluation of the proposals, the Federal Acquisition Regulation (FAR) and the A-76 supplemental handbook require the selection team to conduct specific steps during a "best value" approach. While the private sector offerors can submit proposals that offer a higher level of performance or service, the government in-house management plan and cost estimate base the offer on the PWS. Therefore

the two proposals can differ. When the government's selection authority reviews the private sector proposals to determine which one represents the best overall value to the government, it looks at performance levels, proposal risk, past performance, and cost. Private sector proposals will often offer a higher level of performance or service compared to the original PWS.

In fact, a June 29, 2000 ruling for Rice Services Ltd. held that the selected best value offer becomes the benchmark for the MEO, not the PWS.<sup>39</sup> The selection authority then evaluates the government's MEO to determine if it can achieve the same level of performance and quality as the selected private sector proposal. If not, the government can make changes to the MEO in order to meet the new performance standards. The intent of this step is to ensure that the government bases its in-house cost estimate on the same scope of work and performance levels as proposed by the best value selected private sector offeror. Once the selection authority determines that the two proposals are based on the same levels of performance, the cost estimates are compared.<sup>40</sup>

According to Chapter Four of the A-76 Supplemental Handbook, there must be a minimum cost differential of the lesser of 10 percent of personnel costs or \$10 million over the performance period before converting to or from in-house, contract, or inter-service support agreement performance.<sup>41</sup> The purpose of the minimum cost differential is to ensure the government does not convert for marginal estimated savings.

Any of the participants may appeal the selection authority's decision if they believe that the costs submitted by the winning offeror were not fair, accurate, or calculated according to the procedure outlined in the A-76 Supplemental Handbook. The appeal process can be used

in the Invitation for Bids or Request for Proposal process, whichever is used. The participant making the appeal must do so in writing within 20 days after the date that all supporting documentation is made publicly available. The Appeal Authority has 30 days to adjudicate any appeals after they are received. While DoD continues to use the A-76 process, the Services are looking for alternatives to achieve savings. One such alternative that will be discussed next is strategic sourcing.

### Strategic Sourcing

On April 3, 2000, the Under Secretary of Defense for Acquisition, Technology and Logistics published interim guidance on strategic sourcing programs. The guidance broadens DoD's competitive sourcing tools to include strategic sourcing as an alternative means to achieve savings in areas that are exempt from the A-76 competitive process. The strategic sourcing program is designed to perform functional assessments to determine if processes can be eliminated, improved, or streamlined regardless of whether activities are commercial or inherently governmental in nature.<sup>42</sup> One fundamental advantage of strategic sourcing over the traditional A-76 approach is that strategic sourcing generates smarter business decisions because it addresses the question of whether a function should be performed at all before answering the question of who should perform it. The traditional A-76 process lacked this first step.

Strategic sourcing is not an avoidance of the traditional A-76 process. The new approach however, focuses on functions rather than billets. This enables DoD to make business decisions based on an enterprise-wide basis versus a compartmentalized approach. The advantage of strategic sourcing is that it provides a more holistic approach in analyzing areas under study because many organizations consist of

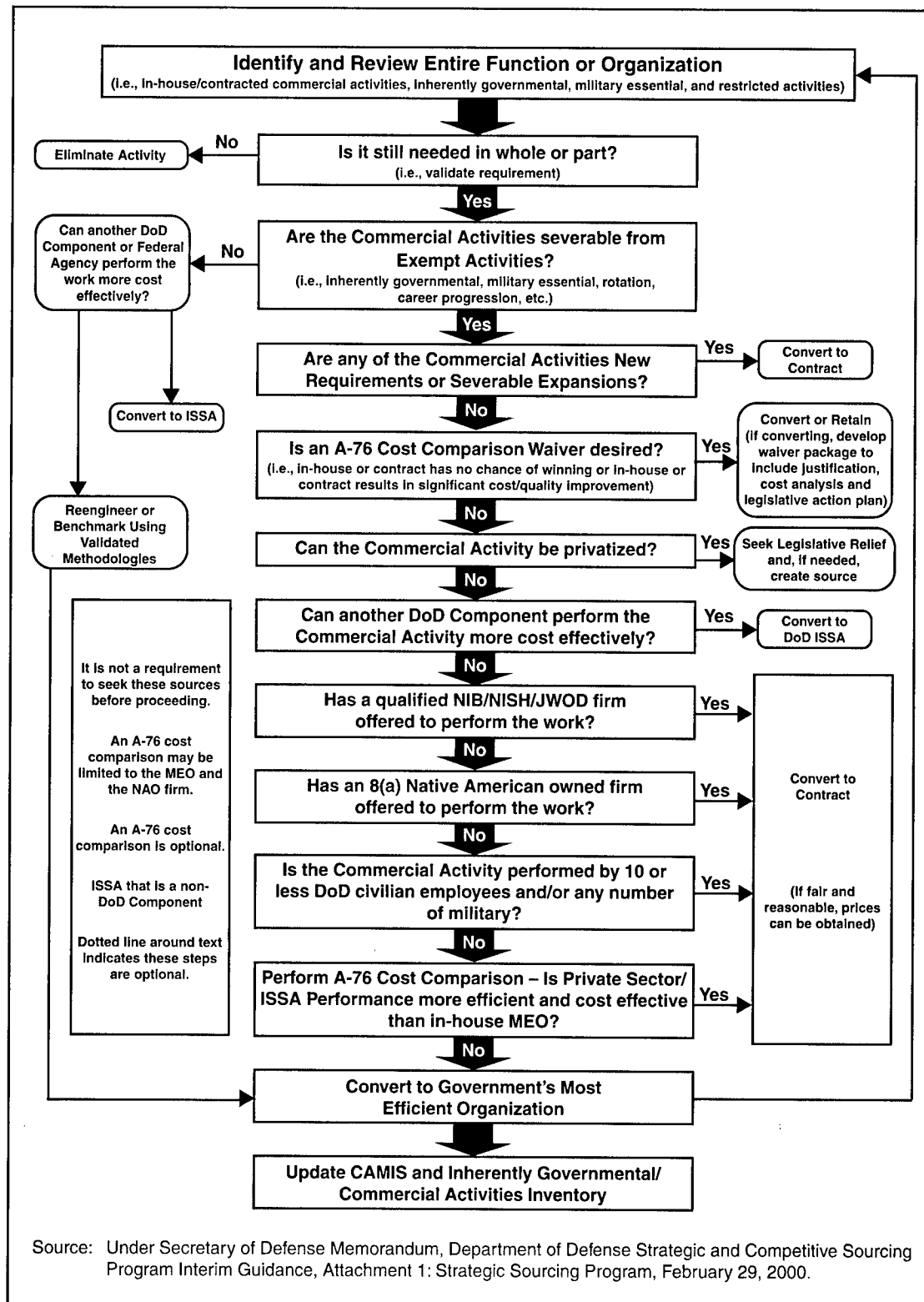
an embedded mixture of functions that are both inherently governmental and commercial in nature.

The move towards strategic sourcing was made because of the realization that conducting A-76 studies alone would not achieve the necessary savings goals and study goals as originally planned, and the A-76 process would not in all cases result in the most efficient infrastructure. Figure 4-12 shows the strategic sourcing decision process.<sup>43</sup>

The key step in the strategic sourcing process is to properly define the entire function or activity to optimize or improve the level of performance at a reduced cost. This procedure is accomplished regardless of whether the function or activity is commercial or inherently governmental. The decision process in Figure 4-12, enables the Service components to consider a wide range of options. Functions that cannot be eliminated, combined, or converted to private sector performance are candidates for functional assessments, a process reengineering-based approach designed to achieve the most efficient operation.

The Navy was the first Service to implement the new approach and expects to review 88,000 civilian positions by 2005. About half of the 88,000 positions will be under the A-76 cost comparison process and the other half through the strategic sourcing process.<sup>44</sup> The Naval Sea Systems Command's Weapon Station at Crane, IN, served as the strategic sourcing pilot program for the Navy. The program began in FY 1998 and expects cumulative savings of \$158 million by FY 2005.

Crane initiated its strategic sourcing approach in 1998 after receiving DoD guidance to cut \$20 million from its annual budget by 2005. The cut put 576 of the base's 3,100 jobs in jeopardy. Duane Embree, executive director at



Source: Under Secretary of Defense Memorandum, Department of Defense Strategic and Competitive Sourcing Program Interim Guidance, Attachment 1: Strategic Sourcing Program, February 29, 2000.

**Figure 4-15. Strategic Sourcing Program Decision Tree**

Crane stated, "We felt we were facing a death of 1,000 cuts. Outsourcing those jobs would have fragmented Crane without our becoming a better organization."<sup>45</sup>

Rather than plunge into an A-76 study, Crane's management team sought permission to waive the immediate outsourcing process in lieu of conducting a comprehensive review of the entire workforce to decide what tasks should be streamlined, eliminated, or if need be, outsourced. For example, the intent was not only to review the base's 1,330 support jobs, traditionally under the purview of A-76, but also to expand the reengineering process to review the 1,700 core scientific, engineering, and technical positions. The core positions are normally in the inherently governmental realm. By 2005 Crane expects to save \$44 million annually. This more than doubles the initial savings directed by the Navy. At Crane, the managers and workers not only look for ways to increase efficiency but also ask the fundamental question, should government employees perform the function in the first place? According to Navy Captain Scott Wetter, Crane Commander, "If we have no value to add, we should go away. It's as simple as that."<sup>46</sup>

Each of the other Services will begin strategic sourcing in 2001. In the upcoming years through 2005, the Army plans to open 18,000 jobs to strategic sourcing and the Marines 7,000.<sup>47</sup> The Air Force is considering about 14,000 positions.<sup>48</sup>

## Results to Date

The competitive sourcing program is one of the most scrutinized programs in DoD because of the billions of dollars at stake and the long-term effects on the federal workforce. Congress, industry, unions, and DoD all have their arguments both pro and con of the long-term value. The oversight and reporting requirements

continue to grow especially with the new administration and the call for transformation. In FY 2000, the GAO published five studies on competitive sourcing, three in the month of August alone. The RAND Corporation, the Center for Naval Analysis, and a host of other organizations have also produced many recent reports on the subject. Even with the oversight and reporting, the debate continues as to the actual long-term savings and benefits of the program. However, many of the reports do produce some common themes to both the benefits and shortcomings of the current system and recommendations for the future. The remainder of this chapter will discuss these findings.

In the most comprehensive review to date, Congress required DoD, in Section 8109 of the 2000 Defense Appropriations Act, to report on all instances since 1995 in which missions or functions of DoD were reviewed pursuant to OMB Circular A-76. The Act required DoD to furnish detailed information for each study. Figure 4-13 shows the requirements for the report. In the report, DoD cited 286 A-76 studies involving 10,661 manpower authorizations.

Of the 286 studies reported, 138 involved cost comparisons (91 percent of manpower authorizations) between the public and private sector, while the remaining 148 studies (9 percent of the manpower authorizations) involved direct conversions either to or from government in-house performance.<sup>49</sup> Of the 138 cost comparisons, 83 (60 percent) were won by the government team while the private sector won the remaining 40 percent. Of the 148 direct conversions, 134 were moved to the private sector. Of the 286 studies, only eight involved work performed by the private sector. In those cases, six were cost comparisons with the public and private sector each winning three. The remaining two private sector studies resulted in direct conversions from the private to the public sector.<sup>50</sup>



**Section 8109. (a): Report on OMB Circular A-76 reviews of work performed by DoD employees.**

- Report on all instances since 1995 in which missions or functions of DoD have been reviewed pursuant to OMB Circular A-76
- Disposition of each review
- Provide the outcome for each study
- Include a description of the types of missions or functions
- Locations
- If applicable, the name of the contractor performing the work
- Cost to perform the missions or functions at the time of the review
- Current cost to perform the mission or function

**Section 8109. (b): Report on OMB Circular A-76 reviews of work performed by DoD contractors.**

- Report on all instances where work has been converted to DoD civilian or military
- Include a description of the types of missions or functions for each instance of contracting in
- Locations where the work was performed
- The name of the contractor that was performing the work
- Cost of the contractor performance at the time the work was contracted
- Current cost to perform the mission or function
- Recommendations for maximizing the possibility of effective public-private competition for work that has been contracted

**Section 8109. (c): Comptroller General Review.**

Not later than 90 days after the Secretary submits the report, the Comptroller General shall submit whether the department has complied with the requirements of the report.

**Figure 4-13.**

**Requirements of Section 8109 of the 2000 Department of Defense Appropriations Act**

The Department reported significant savings in its analysis. The report back to Congress states, “Overall, the 286 A-76 reviews reduced costs by an estimated 39 percent for FY 1999, yielding an estimated \$290 million in savings. This estimated 39 percent reduction is a ‘snapshot in time’ for the 286 reviews in 1999 only.”<sup>51</sup> However, while GAO agreed that savings were being realized from the competitive sourcing studies and acknowledged DoD’s attempts for accuracy, limitations in baseline cost data, study costs, and other factors made it difficult to sub-

stantiate the estimated savings suggested in DoD’s report.<sup>52</sup>

**Factors that Influence Savings**

Many of the common research themes that raise questions as to the actual amount of savings stem from the problems with study initiation, development of baseline costs, unrecognized costs, tracking savings, and completing planned studies. The following sections will discuss each one of these topics in more detail.

## Study Initiation and the Performance Work Statement

In the area of study initiation, a concern is the development of the Performance Work Statement (PWS). The entire cost comparison process hinges on the PWS. The OMB Circular A-76 requires a performance-based PWS. The team developing the PWS must describe what results need to be achieved, not how to achieve those results. A well-crafted PWS describes the desired performance level in terms of quality, quantity, and timeliness. A poorly developed PWS often leads to customer dissatisfaction, contractor default, and reduced efficiency and effectiveness by stifling the creativity of the marketplace to develop innovative solutions to unique problems.

Although on the surface it appears an easy task to write the PWS — describe what you want done — the government team walks a fine line during the PWS development. The team must strike a balance between ensuring the PWS describes the desired outcomes and not becoming too prescriptive. In a study published by the Center for Naval Analysis in February 2001, the report cited several examples of an overly

prescriptive PWS. The purpose of the study was to determine the long-term costs and performance effects of DoD's competitive sourcing program. The study analyzed 16 completed competitions and attempted to determine cost savings for each. The study found nearly all the PWSs required the potential contractors to follow vast numbers of military instructions or manuals. Specific examples include:<sup>53</sup>

- The type of grass seed to use;
- The numbers of insects that must be counted before initiating treatment;
- The number and type of personnel the contractor was to provide;
- The use of government paint specifications for housing.

Figure 4-14 provides further illustration where an overly prescriptive PWS will lead to unnecessary costs.<sup>54</sup> Part of the problem is due to the make up of the team writing the PWS. This team normally includes in-house workers who are already performing the tasks. Therefore, it is quite natural for them to think in terms of

In May 1998, the Air Force Audit Agency reviewed the mess attendant contract at McConnell Air Force Base to determine if this outsourced function was effectively and efficiently managed. Their review of the existing contract and the Invitation for Bids (IFB) for the follow-on contract found the contract requirements were overstated and included work which was no longer needed. For example, the PWS overstated the monthly meal count by nearly 7,000 meals (20,000 monthly meals as opposed to an historical usage of 13,000) and the IFB included provisions for short order cooks even though cooking duties were not part of the mess attendant contract. The PWS also indicated that the contractor was responsible for the watering of live plants, dusting silk plants, and dry-cleaning the drapes within the dining facilities. However, a separate contractor receives \$2,400 a year to maintain the live plants, there are no silk plants in the dining facilities, and the drapes were replaced with venetian blinds nearly five years prior. By revising the PWS to better match anticipated workload requirements with its actual need, the Air Force can reduce its operating costs by \$381,000 annually.

**Figure 4-14. Overly Prescriptive PWS Example**

the old way of doing business and describing the work as it is currently performed. A second potential problem is that the people who write the PWS could be the same people who create the in-house MEO. This creates a conflict of loyalties. Rather than opening avenues for creativity and innovation, it hinders change to new ways of solving problems. Potential solutions are to give more training in best commercial practices of PWS writing to those who perform the function, or to assign the writing to a separate, non-partial group. The need for a good PWS cannot be overstated. In fact the DoD Inspector General has reported that 70 percent of increases in outsourced contracts result from changes in the PWS.<sup>55</sup>

### **Baseline Cost Estimates**

A second issue affecting the government's ability to determine savings is the development of the Baseline Cost Estimate (BCE). This is due to several factors. First, the BCE uses an average salary for the positions under study, as opposed to actual costs. Second, the salary and benefits are computed on the number of positions authorized instead of the actual positions filled. Using the actual costs provides a more realistic baseline to determine savings as a result of the competition because the "baseline" is an inflated number to begin with.

In an August 2000 study conducted by the GAO entitled *Savings Are Occurring But Actions Needed to Improve Accuracy of Savings Estimates*, GAO analyzed nine A-76 competitions. The GAO found a variety of cost estimating approaches. Of the nine, GAO found seven cases where the component used personnel reductions as a baseline for estimating savings. Along with the two issues discussed above, GAO also found that while most of the savings were attributed to personnel costs, nearly 15 percent of the costs for the MEO or contractor were not, in fact, personnel costs. However,

these were not included in the BCE. Neither GAO nor DoD could accurately determine the savings in any of the nine cases analyzed.<sup>56</sup>

An example of the problems associated with determining a true baseline cost can be shown in one of the cases GAO reviewed in the study. The case involved a missile maintenance activity at Redstone, AL. The activity had several organizational changes occurring independent of the study. Some of these changes included a reduced workload of 40 percent and decreased personnel requirements. However, these changes were included in the baseline cost estimate. At the time of the review, neither GAO nor the base officials could separate or estimate the reductions related solely to the A-76 study.

It should be noted DoD has recognized the problem with BCEs. On March 14, 2001, DoD published DoD 4100.XX-M, A-76 Costing Manual. The document provides policy and procedures to develop the in-house cost estimate for the competitive sourcing program. Proper implementation will go a long way in helping DoD correct this known deficiency but it will not affect the hundreds of studies already undertaken which comprise the bulk of the estimated \$11.7 billion in savings that DoD hopes to achieve from the program.

### **Unrecognized Costs of the Competition**

The savings from the competitive sourcing program do not come without a price. These costs fall under the category of unrecognized costs. These costs are considered unrecognized because they are not taken into account in reporting the savings associated with the competitive sourcing program. As will be shown, these costs can be substantial. Four factors make up unrecognized costs. These factors are the costs to conduct the study, personnel transition costs, contract administration costs, and scope of work changes.

The first factor is the costs associated with conducting the study. A-76 competitions have proven to be extremely manpower-intensive. The government team must develop the PWS, QASP, and MEO; conduct the source selection board; and award the contract. These activities take time and pull personnel away from their normal duties. In many cases, these are the same duties that the government plans to compete. The exact costs to conduct each study (per position) can vary considerably from Service to Service and from competition to competition. The Services use a planning figure of \$2,000 per position.<sup>57</sup> However, this number can be much higher. One source estimates that it costs between \$2,000 and \$6,000 per position competed.<sup>58</sup>

In the study involving the nine cases discussed earlier, GAO estimated the cost per position ranged from \$364 for a Navy child care center in San Diego, CA, to almost \$9,000 for a Navy regional family services center also in San Diego.<sup>59</sup> Based on these figures, the cost to conduct the A-76 competitions can run into the millions of dollars. According to the President's Budget for FY 2001, DoD estimated \$555 million in study costs for A-76 and strategic sourcing studies for FYs 1997-2005. If the actual costs to conduct the studies rose to a not uncommon \$4,000 per position, the study costs would erode over \$1 billion in overall projected savings by DoD (roughly 10 percent).

The second category of unrecognized costs are the personnel transition costs associated with implementing the competition award. These costs take the form of separation costs for reductions in force, voluntary separation incentives, severance pay, placing affected employees in other positions, and reassigning uniform personnel back to operational assignments. Typically, most of the sourcing competitions involve some type of service activity. Therefore, the costs associated (and hence the savings)

with the activity are mostly personnel costs. However, like the costs to conduct the study, transition costs can be high — particularly in cases involving the transition from military positions to government civilian or contractor personnel.

Referring back to the GAO study, Altus Air Force Base shows the impact of transition costs on estimated savings.<sup>60</sup> Of the nine cases analyzed by GAO, Altus represented the largest savings over a five-year period—almost 38 percent. In the Altus example, 97 percent of the costs identified in the MEO were personnel-related. In 1996, the Air Force planned to convert its largely military aircraft maintenance workforce at Altus into either government or contractor employees based on the results of their A-76 study. The existing organization had 1,444 authorized positions (1,401 military and 43 civilians); however, the actual number assigned was 1,248 (1,206 military and 42 civilian). Altus had 14 percent fewer workers on hand than authorized. The government's MEO won the competition. The MEO had 735 civilian positions. The case reported significant savings due to the reduction in personnel costs. The five-year baseline cost for the existing operation was \$265 million while the MEO cost \$166 million. However, when one takes a Service-wide outlook, the savings to the Air Force were much smaller because the salaries of the 1,248 military never really went away. Additionally, over the five year period from 1996 through 2001, the Air Force estimated it would cost \$3.7 million in "save pay." Save pay refers to the money given to a federal employee to compensate for the lower pay when, during the course of a reduction in force, the employee moves to a lower-graded position. The employee retains his or her pay according to the previous pay grade. One could argue that the net effect was actually an increase to the Air Force payrolls of 735 personnel.

The Altus example also shows the impact of using actual versus authorized positions as discussed in the problems with the baseline cost estimate portion of this chapter. Just by using actual numbers the BCE would show significant savings while no change to the existing organization.

The Services show no indication of reducing military end strength as a result of the competitive sourcing program. Putting soldiers, sailors, and airmen back into warfighting units is a good thing. However, their salaries don't really disappear from the Service budgets. Therefore while Altus can claim a savings in isolation, the overall impact to the Service is much less. In fact, the Services plan to study the activities involving 44,816 military positions.<sup>61</sup> The results of these studies will most likely replace the uniform personnel with government or contractor personnel. Another significant point to the change of workers is that the Services will have to increase their operations and maintenance accounts to pay the salaries of the government or contractor employees. The transfer of positions with subsequent inflation of the savings numbers has not gone unnoticed among critics. According to Bobby Harnage, president of the American Federation of Government Employees, "We have heard a lot of lies the last few years about how much smaller DoD's workforce has become. DoD's workforce has not gotten any smaller; it's merely been reconfigured."<sup>62</sup>

A third unrecognized cost category is the administrative costs to oversee contracts when a private firm wins the competition. Just as the other costs described above, these costs can vary significantly based on the type and size of the activity in question. For example, in the nine GAO case studies, the private sector firm won six of the competitions. The administration costs of these six cases ranged from a low of \$12,000 per year for the child care center in

San Diego, to over \$635,000 per year at Wright-Patterson Air Force Base for base operations support.<sup>63</sup> Like the cost to conduct the study and transition costs, administration costs are not factored into the reported savings estimates.

The fourth unrecognized cost involves changes in the scope of work, which can make it virtually impossible to compare estimated savings at the beginning of the competition to actual long-term savings. Sometimes the changes occur as a result of inadvertent omission of tasks from the original scope of work which must be added back in. Other times the changes occur due to organizational changes that increase or decrease workload functions. The GAO found several examples of changes in scope during its analysis of the nine cases. In one such instance, a scope of work change added 6 percent to the original contract cost.<sup>64</sup>

### **Tracking Costs**

In order to evaluate the success of the competitive sourcing program, DoD must improve its ability to document actual program costs and program changes. Without this documentation, DoD will never be able to accurately determine the program's effectiveness and efficiency. This takes on added importance as the leadership continues to make budgetary decisions based on inaccurate and inflated cost savings estimates. The research shows numerous examples of the lack of clear and accurate cost reporting and the difficulties in determining long-term savings. This section will discuss some of the problems of tracking costs using examples from recent studies.

One of the factors discussed as a continuing problem with cost reporting is the Commercial Activities Management Information System (CAMIS). When the leadership at an installation selects an activity for a cost comparison, they establish a CAMIS data file to record

the results of their competition. The data file contains information such as cost comparisons, functions, milestones, and the outcome. The GAO has repeatedly expressed concerns about the accuracy and completeness of the CAMIS data beginning as early as 1990.<sup>65</sup> This is particularly true in cases involving in-house wins where the records of cost performance and workload changes have not been routinely kept up-to-date. For example, in its report entitled *Results of A-76 Studies Over the Past Five Years*, GAO noted that in the section 8109 report DoD submitted to Congress, DoD excluded information of 53 studies (nearly 20 percent of the studies conducted over the past five years) due to lack of data.

The lack of accurate data was also cited in the February 2001 Center for Naval Analysis report, *Long-Run Costs and Performance Effects of Competitive Sourcing*. The original intent of the study's authors was to report on 30 competitions with an equal number of in-house and contractor wins. However, insufficient and missing data eliminated about two-thirds of the 49 competitions initially selected for review. The group found the inaccuracies were particularly prevalent for in-house wins. Out of the 24 in-house wins initially reviewed, they only found sufficient data to report on two. The overall lack of historical data forced the study group to report on only 16 studies, two in-house and 14 contractor wins.<sup>66</sup> Although the study concluded that long-term savings do exist, the need to reform the process to ensure accurate data was cited as an improvement that must be made for DoD to better evaluate the competitive sourcing program's effectiveness.

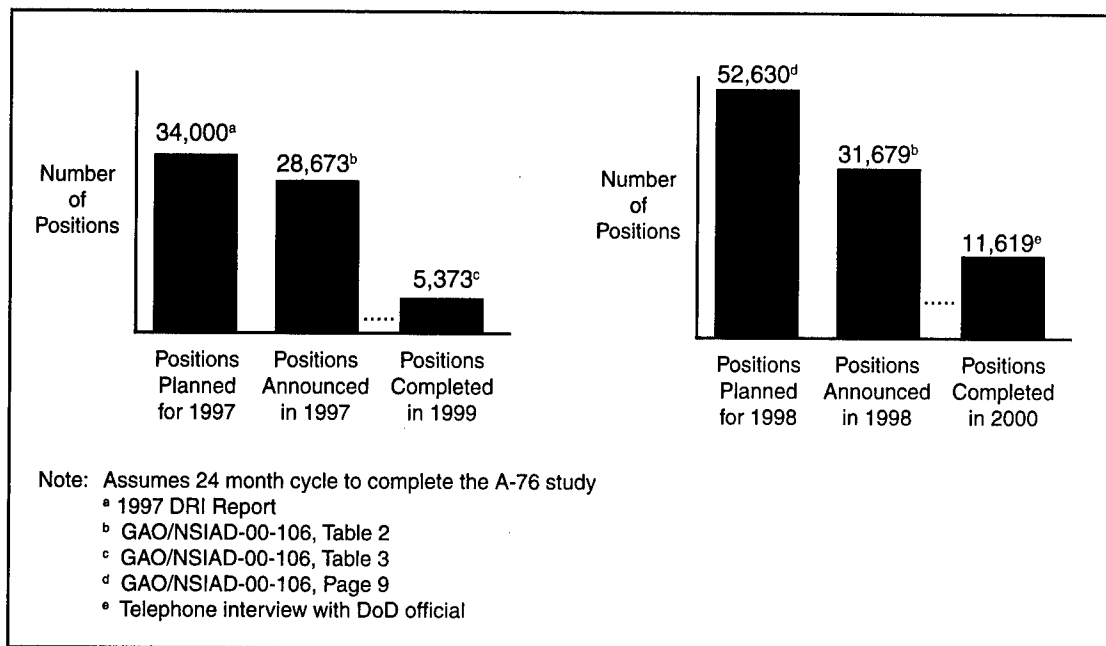
To its credit, DoD has recognized the problems with the CAMIS database and is under a massive review in an attempt to update over 1,500 files. Additionally, they will move to a web-based program to provide real-time data for better tracking. This should help alleviate some

of the problems. However, proper controls must be placed in the system to ensure that users continue to update the information. Data that are not current are useless — as the computer axiom points out: “garbage in” equals “garbage out.”

### Initiating and Completing Studies

As part of the DRI, DoD set very aggressive A-76 goals in terms of the number of positions to study and the associated estimated savings. By taking the anticipated savings away up front, the pressure is now on to produce. The challenge remains to complete the number of planned studies and achieve the results. For example in 1999, DoD established a goal to study nearly 230,000 positions and save \$11.2 billion between 1997 and 2005. However, as a recent GAO report indicates, DoD has fallen behind in its plan for initiating the planned amount of studies and has had some difficulties completing the studies within the two-year goal.<sup>67</sup> Some of the factors that contribute to DoD's difficulty in increasing the number of positions studied under A-76 were discussed in the FAIR Act portion of this chapter. This challenge has forced DoD to look for other ways to achieve its goals, such as the strategic sourcing initiatives discussed earlier in the chapter, reorganizations and consolidations, and the use of direct conversions.

Figure 4-15 illustrates the difficulty DoD has had in accomplishing its goals. Although some assumptions went into building the graphs, they do show a significant trend. Since DoD based its budgetary savings estimates on planned studies, one would conclude that DoD will not achieve its anticipated savings within its expected timetable of 2005. We use the two most recent years in which there would be complete data to illustrate this point. The figure assumes a two-year completion estimate to formulate the graphs. The reported number of completed



**Figure 4-15. Comparing Planned Versus Completed A-76 Data**

studies may not have all been started exactly two years before but one can see a definite trend in relation to planned versus completed. For instance in the 1997 bar graph, the number of studies completed in 1999 does not necessarily mean those studies were started in 1997. Some could have been started in prior years or in 1998. The same is true for the studies completed in 2000. Those studies may not have all started in 1998. However, even if the completed studies for 1999 and 2000 do contain studies initiated in other years it still shows a significant decrease in completing the studies which in turn would not enable DoD to generate the savings that have already been taken out of the budget. In 1997, DoD planned on conducting studies totaling 34,000 positions but actually announced 28,673 positions. Two years later, DoD had only completed enough studies to total 5,373 positions of the announced positions in 1997.

The relationship between announced and completed studies is not a recent trend. In a 1997

RAND documented briefing entitled *Cancellations and Delays in Completion of Department of Defense A-76 Cost Comparisons*, the authors analyzed A-76 cost comparison data from FYs 1978 through 1994. The analysis found that between those years, approximately five A-76 cost comparisons were canceled for every eight completed (2,268 total cost comparisons and 1,418 were canceled).<sup>68</sup> Additionally, the briefing found the mean time to complete the studies was 810 days and over 10 percent of the cost comparisons took at least four years.

The trends in Figure 4-15 and in the RAND brief raise two other important points. First, if a competition is canceled, this generally means those functions remained in house and the government's in-house team is under no obligation to change according to what would be the MEO. Second, since DoD expects to generate about 30 percent savings on each completed competition, taking into account that historically 40 percent of the initiated

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competitions are subsequently canceled, the expected savings for each initiated competition will therefore be much less.

### **Summary**

In this chapter, we have shown the clear linkage between the National Security Strategy, National Military Strategy, and DoD corporate strategy. This linkage is imperative. A corporate strategy that is aligned to the overarching strategies ensures the business functions of DoD support the effective and efficient attainment of the nation's security and military objectives. However, by using the sole performance measure of the number of positions subject to A-76 competitions and strategic

sourcing reviews, DoD has turned the competitive sourcing program into a manpower-driven exercise, not a value-based one.

This analysis pointed to specific areas of improvement sought by DoD. The Department is implementing an RBA with the purpose of freeing resources for the RMA. As part of this RBA, DoD has undertaken OMB Circular A-76 and strategic sourcing initiatives. The objective of these initiatives is to generate the cost savings needed to fuel the RMA. The results presented appear promising. However, there are clear challenges facing DoD in the attainment of its goals. In the next chapter we look in more detail at the results and whether they can meet the objective.



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One should note that GAO found DoD excluded information on 53 studies completed during 1999 because the information was incomplete when DoD compiled its report in June 2000. Further analysis of the 53 studies did not dramatically change the results. The percentage of cost comparisons resulting in private sector performance increased from 40 percent to 41 percent. The number of direct conversions increased to 195 studies which was an increase of six. Finally, the number of currently performed private sector studies did not change from the originally stated eight.

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# 5

## WHY RESULTS HAVE BEEN MARGINAL

*“Never give an order unless you are certain it will be carried out.”*

— General Douglas MacArthur

### Introduction

In Chapter Four, we examined the business strategy of the Department of Defense (DoD) and the results to date. As we saw, DoD is committed to driving down infrastructure costs primarily through public/private competitions modeled around Office of Management and Budget (OMB) Circular A-76 (A-76). This is being done in an effort to free up funds for force recapitalization and as a means to finance day-to-day operations. As we illustrated, despite aggressive efforts to meet savings targets, DoD has attained only limited success.

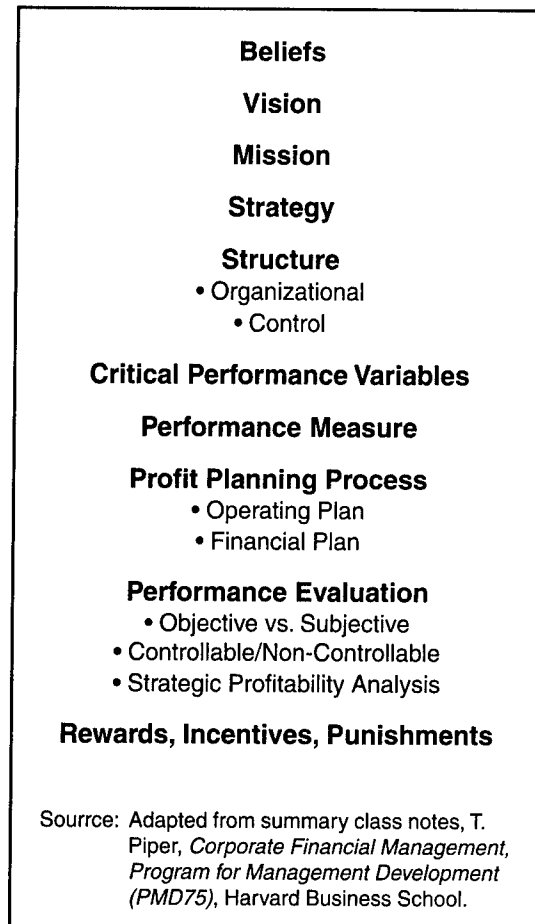
This chapter addresses why the results of A-76 initiatives and their derivations have fallen far short of expectations and why further pursuit of this strategy will be likely to generate only marginal results. More important, we examine how this focus on efficiency may result in adverse consequences (eroding business advantages that DoD has long held) and removing value. We address not only the indicators that demonstrate that A-76 is a flawed business strategy, but also the underlying causes. These

causes include a review of systems, processes, and culture that must be addressed before implementing any strategy.

In this chapter we cite data collected from a survey administered and analyzed as part of our research. This survey was sent to a sample of approximately 1,300 DoD personnel; 234 responses were received. Questions focused on DoD business strategies, outsourcing initiatives, and the alignment of strategy to outsourcing. Appendix D contains a complete description of the survey methodology, the questionnaire, and a complete summary of results.

### A Strategic Framework for the Department of Defense

In Chapter Two we introduced a strategic framework and order of precedence that may be used to understand and analyze business strategy. We now take that framework and use it to assess DoD. By way of review this framework consisted of the following items in Figure 5-1.



**Figure 5-1. Strategic Framework**

Aligning these elements is a critical component of any successful strategy. One flows from the other. When well crafted and well integrated, this framework drives a successful enterprise. However, when these elements are incompatible or misaligned, the resulting incongruities stifle performance and produce marginal results. In this section, we explore the first three of these elements: beliefs, vision, and mission.

### **Belief Systems**

In his book *Levers of Control*, Robert Simons defines belief systems as “the explicit set of organizational definitions that senior managers

communicate formally and reinforce systematically to provide basic values, purpose, and direction for the organization.” Simons goes on to say that these beliefs “espouse the values and direction that senior managers want subordinates to adopt.”<sup>1</sup> With that definition in mind, we begin this section with examples of these beliefs and the people who have adopted them. The following excerpt is taken from the Center for Strategic and International Studies (CSIS) study entitled *Report on American Military Culture in the Twenty-First Century*.

On the dusty back streets of Mogadishu, Somalia, on October 3, 1993, two U.S. Army sergeants did the nearly unthinkable. While their helicopter hovered over another downed helicopter to provide air cover to its wounded occupants, Sergeants Gary Gordon and Randall Shughart came under such heavy enemy fire that their own chopper could not remain on station. Unwilling to abandon fallen comrades, Gordon and Shughart volunteered to stay behind to face insurmountable odds. Permission was reluctantly granted.

Lowered by rope to the ground, Sergeants Gordon and Shughart extricated the wounded pilot of the downed helicopter under withering enemy fire, an action that the pilot, Chief Warrant Officer Michael Durant, believes saved his life. Gordon and Shughart held off the growing number of attackers until their own ammunition ran out, and they were killed. Both Gary Gordon and Randall Shughart were posthumously awarded the Medal of Honor.

Several years later, on routine naval operations in Pusan Harbor, Korea, when one of Ensign Daniel Johnson’s men

became entangled in a line that was pulling him to a probable death, Ensign Johnson rushed to his aid. The citation of the Navy and Marine Corps Medal that was awarded to Ensign Johnson stated, "Immediately, without hesitation, and in the face of known risk to his own life, Ensign Johnson ran to the assistance of the entrapped line handler." The sailor survived with the loss of a leg and four fingers. Ensign Johnson lost one finger and both legs below the knee. Columnist George Will later wrote that Johnson said he took that action because "...officers are trained to be responsible for the well being of their men." From his hospital bed, the brave young officer said of his Navy experience: "I developed a lot of self-confidence when I was doing my job. No regrets."<sup>2,3</sup>

We could go on to cite many other examples of heroic actions taken by U.S. servicemen and women throughout history. These are actions taken in both war and peace, actions taken often with utter disregard to personal safety. They are actions taken completely absent the motivation of stock options, profit sharing, or sales goals. And they are taken because of deeply held beliefs: loyalty to comrades, commitment to a team, a belief in something that goes beyond personal well-being.

The belief systems of DoD and the Services emphasize integrity, personal accountability, and a sense of duty. This is no accident. To a large degree these beliefs are what sets the military apart and they play a large part of what drives ordinary people to do extraordinary things.<sup>4</sup> From the first day in uniform, military personnel are told that they are part of a proud tradition, that they have accepted a noble calling, and that they have a duty that goes beyond each one of them personally.

Arguably, this is one of the reasons that the Services attract and retain talent in an environment where the private sector offers better pay and conditions. This is borne out by a 1999 General Accounting Office (GAO) Survey which cited *military values and lifestyle* as the most frequently selected reason among officers assigned to critical specialties who decided to stay in the military. This was followed by *esprit de corps* as the second most frequently cited reason. Among enlisted members, *military values and lifestyle* ranked as the fourth most frequently cited reason. For both officers and enlisted personnel, these reasons ranked ahead of *base pay*.<sup>5</sup>

These beliefs are also aptly expressed by the quotes of veterans who decided not to make the military a career and by the people who employ them. The following quotes were taken from recent interviews conducted by DoD.<sup>6</sup>

"Being mission-focused...being oriented towards one thing is really what I brought over to civilian life."

Tony Dumaine, U. S. Army

"I realize now that it instilled in me discipline, motivation, loyalty...values the military likes to promote."

Matthew Bernard, U. S. Army

"Many values — like integrity, adaptability, loyalty — are instilled into the individual while they're in the service. These values stay with them when they get out, and are with them for life."

James Klasek, Director of Recruiting  
Premier Technology Group, Inc.

These sentiments speak eloquently as to the degree these beliefs permeate and define military culture and with it, the culture of DoD in general. These values are shared by those in

uniform and by civil service personnel within the Department.

The power of a set of core beliefs, long understood by the military, has not been lost on leaders in the business world. They understand that, in business as in the military, a strategic framework starts with a set of belief systems that defines the organization. As we stated in Chapter Two, attaining business success, or anything worthwhile in life for that matter, is likely to be a difficult undertaking. The same is, of course, true of military success. It is likely to be exceedingly difficult and, unlike most business enterprises, extremely dangerous. In both cases, belief systems ensure the journey is worth taking in the first place and that the effort is worthwhile.<sup>7</sup> What, other than a strongly held set of beliefs, would allow someone who had lost both legs to say he had “no regrets.”<sup>8</sup>

In this context it is easier to understand why successful businesses place a great deal of value on strong belief systems. Strategy is built on the foundation of a strong set of core beliefs, the ability to define the worth of the endeavor, and the power to motivate and to define how

the members of the organization will conduct themselves. These systems define the organization and as such they are the responsibility of the leadership structure to communicate and reinforce. Belief systems provide basic values, purpose, and direction for the firm.<sup>9</sup>

When properly crafted, belief systems provide inspiration, momentum, and direction.<sup>10</sup> In Chapter Two, Figure 2-12, we cited Johnson & Johnson’s Credo as an example of a set of codified beliefs that guide the firm. Note that maximizing profit is not the principal reason for Johnson & Johnson’s existence, nor is it the principal reason for most high performance companies.<sup>11</sup> As Simons points out, “Higher ideals are needed to instill pride and motivate productive effort.”<sup>12</sup>

DoD has long embraced high ideals and the pride they instill. No less powerful and no less compelling than corporate belief systems are the credos of the uniformed services. Table 5-1 lists these guiding principles.

Note that just as maximizing profit is not the principal reason for existence with high

Army	<ul style="list-style-type: none"> <li>• Duty</li> <li>• Honor</li> <li>• Country</li> </ul>
Navy and Marine Corps	<ul style="list-style-type: none"> <li>• Honor</li> <li>• Courage</li> <li>• Commitment</li> </ul>
Air Force	<ul style="list-style-type: none"> <li>• Integrity</li> <li>• Service</li> <li>• Excellence</li> </ul>
Coast Guard	<ul style="list-style-type: none"> <li>• Honor</li> <li>• Respect</li> <li>• Devotion to duty</li> </ul>

**Table 5-1. Guiding Principles of the Uniformed Services**

Which of the following issues are important considerations when conducting an outsourcing study?			
	Impact on Cost	Impact on Personnel	Impact on Mission Performance
Strongly Agree	36.5%	57.9%	77.2%
Agree	51.1%	33.1%	19.4%
Neither Agree nor Disagree	6.4%	4.3%	0.9%
Disagree	3.9%	3.0%	0.4%
Strongly Disagree	2.1%	1.7%	2.2%

**Table 5-2. Importance Attributed by DoD Personnel Regarding Impact of Outsourcing**

performance companies, minimizing cost is not listed as the principal reason for existence among the uniformed services. Guiding principles go beyond this. Additionally, just as these principles define a set of values that the corporation will not go beyond to earn a profit, they define a set of values that members of DoD will not go beyond to generate savings.

This was borne out by our survey data. When asked which of three issues are important considerations when conducting an outsourcing study, impact on mission performance and impact on personnel were cited as considerations that ranked above impact on cost. These data are displayed in Table 5-2.

Respondents were free to indicate that all ranked the same (i.e., respondents could strongly agree with all three) or to differentiate. Note that 96.6 percent of the 233 people who responded to this question either strongly agreed or agreed that impact on mission performance was an important consideration. And 91 percent of those same respondents either agreed or strongly agreed that impact on personnel was an important consideration. Compare this to

87.6 percent of respondents who either agreed or strongly agreed that impact on cost was an important consideration. By contrast, when asked what are the most important objectives of outsourcing, the most often cited response was cost control or cost savings. It would seem that Department personnel understand that outsourcing is being initiated to reduce and control cost, but as these data demonstrate, members of DoD view mission and personnel as more important considerations.

This trend was more pronounced among those 111 respondents who identified themselves as being in a command position. Table 5-3 shows this group broken out separately.

Within this group, 98.2 percent either strongly agreed or agreed that impact on mission performance is an important consideration, 90.9 percent strongly agreed or agreed that impact on personnel is important, and 85.5 percent strongly agreed or agreed that impact on cost is an important consideration. As one might expect in the context of DoD's belief systems, those in command positions are highly concerned with performing their mission and



For respondents in a command position, which of the following issues are important considerations when conducting an outsourcing study?			
	Impact on Cost	Impact on Personnel	Impact on Mission Performance
Strongly Agree	36.4%	60.9%	89.0%
Agree	49.1%	30.0%	9.2%
Neither Agree nor Disagree	8.2%	4.6%	0%
Disagree	4.6%	2.7%	0.9%
Strongly Disagree	1.8%	1.8%	0.9%

**Table 5-3. Importance Attributed by Those in Command Regarding Impact of Outsourcing**

taking care of their people. When outsourcing, cost is not the primary consideration. This is at odds with A-76 — DoD's principal outsourcing tool — which stipulates that cost is the primary consideration.

We return to the examples of heroism that began this section. These examples of uncommon bravery exhibit common traits. They are examples of loyalty, devotion to duty, and self-sacrifice. Commitment to a team, mission accomplishment, responsibility toward others — these are valued characteristics in the military. As such, these actions are revered and rewarded. They are at the core of our belief systems and they embody the values that define military culture. They are also attributes that impact on the execution of outsourcing initiatives, especially cost-driven initiatives.

### Vision

Just as its belief systems are documented and carefully spelled out, so too is the DoD vision. As stated in DoD's strategic plan, it is the vision of the Department to:

- Field the best trained, best equipped, best prepared fighting force in the world.
- Support alliances and security relationships that protect and advance U.S. security interests.
- Further national interests by working effectively with other federal agencies, Congress, and the private sector.
- Serve as a model of effective, efficient, innovative management and leadership.<sup>13</sup>

This vision defines DoD's strategic domain. It is clear, concise, and in complete alignment with the strong belief systems that are the bedrock of DoD and the Services. For many readers, review of this report may be the first occasion they have had to read or reflect on what to us is a compelling and well-crafted vision. This assessment is validated by the contemporary business literature we've reviewed. Recall the critical characteristics of an effective vision described by John Kotter and presented in Chapter Two.<sup>14</sup>

- The vision must be imaginable, conveying a picture of what the future will look like.
- The vision must be desirable, appealing to the long-term interests of employees, customers, stockholders, and others who have a stake in the enterprise.
- The vision must be feasible, comprising realistic and attainable goals.
- The vision must be focused, providing guidance in decision making.
- The vision must be flexible, allowing individual initiatives and alternative responses in light of changing conditions.
- Finally, the vision must be communicable — easy to communicate.

The DoD vision scores well under these criteria. To be the best, to advance U.S. interests, to be highly effective, to serve as a model for others — this describes a vision that is imaginable, desirable, feasible, focused, and flexible. Many companies go to great lengths to articulate such a vision. In our view, DoD's vision is on par with any vision statement found in the business world.

Unfortunately, DoD has fallen short in communicating this powerful vision. Only 35.9 percent of 234 survey respondents have read the Strategic Plan. For the 111 who identified themselves as being in a command position, only a third had read the Strategic Plan. Before the vision can be communicated, it must be read and understood, especially by those in command.

### **Mission**

Belief systems are a core set of values that provide strength and sustenance to the organization.

Vision is the statement of direction and purpose. Mission then follows as a way of meshing these two into a company-specific statement that provides the broad purpose or reason that the business exists.<sup>15</sup> These missions are generally written down in formal documents known as mission statements.<sup>16</sup> DoD is no exception. Here too, the Department and the Services score quite well. In fact, reading DoD's mission statement, one is reminded that the Department's beliefs, vision, and mission predate the modern business literature we are using to evaluate them.

The mission of the Department of Defense is to support and defend the Constitution of the United States; to provide for the common defense of the nation, its citizens, and its allies; and to protect and advance U.S. interests around the world. To accomplish this mission, the Department maintains trained forces ready to respond to threats to U.S. security arising anywhere on the globe.

In peacetime, the United States works with friends and allies to promote a stable world that supports economic growth and provides opportunities for emerging democracies. The routine deployment of U.S. forces overseas, combined with the maintenance of ready forces at home, promotes stability and deters the use of force against U.S. interests. The same military forces that help shape the international environment can also respond quickly to threats to U.S. security when crises arise.<sup>17</sup>

For DoD, beliefs, vision, and mission are well aligned and self-reinforcing. This is depicted in Table 5-4. Taken together, these principles guide us. They dictate, both explicitly and

Beliefs									
Duty	Honor	Country	Commitment	Integrity	Service	Excellence	Respect	Devotion	
Mission					Vision				
To support and defend the Constitution of the United States.					Field the best trained, best prepared fighting force in the world.				
To provide for the common defense of the nation, its citizens and its allies. To protect and advance U.S. interests around the world.					Support alliances and security relationships that protect and advance U.S. security interests.				
To work with friends and allies to promote a stable world that supports economic growth and provides opportunities.					Further national interests by working effectively with other federal agencies, Congress, and the private sector.				
To maintain trained forces ready to respond.					Serve as a model of effective, efficient, innovative management and leadership.				

**Table 5-4. Reinforcing Aspects of DoD Beliefs, Vision, and Mission**

implicitly, what direction DoD will take on a daily basis. Just as the Johnson & Johnson's Credo, Figure 2-12, guides the company through calm and crisis, this strategic framework guides the Department in much the same way.

#### **From DoD Beliefs, Vision, and Mission, to DoD Strategy**

From beliefs, vision, and mission, flows strategy. Recall Porter's generic strategies described in Chapter Three, then review Table 5-4. The DoD and the Services would appear to fit well with a generic strategy of differentiation. DoD seeks to be unique; to be the best trained, best prepared fighting force in the world. The names United States Army, United States Navy, United States Air Force, and United States Marine Corps convey certain meanings. As such they are powerful brand names that carry significant value. The Services rely on this brand image for a number of things including recruiting personnel, acquiring resources, and intimidating would-be adversaries.

Conversely, statements and beliefs in Table 5-4 do not sound like an organization committed to a strategy of cost leadership. The Department does not seek to be the low-cost defense provider worldwide and the Services do not vie for the title of most cost-efficient branch of the armed services.

Yet cost leadership is the goal of outsourcing policies such as A-76 and their derivations. What is the impact of crafting beliefs, vision, and mission to pursue one strategy and simultaneously attempting to pursue another? Recall again Porter's admonition about becoming stuck in the middle, that the pursuit of multiple strategies requiring inconsistent actions and "being all things to all people is a recipe for strategic mediocrity and below-average performance, because it means that a firm has no competitive advantage at all."<sup>18</sup>

Survey data indicate DoD personnel sense this inconsistency of multiple strategies. When asked to respond to the following statement:

DoD is headed in the right direction with respect to outsourcing issues (All respondents)	
Strongly Agree	3.0%
Agree	26.6%
Neither Agree nor Disagree	17.6%
Disagree	35.2%
Strongly Disagree	17.6%

**Table 5-5. DoD Attitudes Toward Outsourcing Policy**

“DoD is headed in the right direction with respect to outsourcing issues,” only 29.6 percent of 233 respondents agreed or strongly agreed. Those disagreeing or strongly disagreeing with this statement represented 55.8 percent of respondents. A summary of responses is depicted in Table 5-5.

If these data are representative, it's quite remarkable that DoD is aggressively pursuing outsourcing policies that so many disagree with. More striking still are the 111 respondents in command positions. Of this group, 56.7 percent either disagree or strongly disagree that DoD is headed in the right direction with regard

to outsourcing. Their responses are shown in Table 5-6.

These are the very people charged with execution of A-76 and related outsourcing initiatives. It would appear that these individuals do not necessarily embrace DoD outsourcing policy in its current form.

Continuing this line of analysis, we looked specifically at the 78 respondents in positions of command who have been involved in an outsourcing effort. Their attitudes are even more pronounced. Of this group, fully 64.1 percent disagree or strongly disagree that DoD is

Respondents in a command position responding to the statement: DoD is headed in the right direction with respect to outsourcing issues	
Strongly Agree	3.6%
Agree	24.3%
Neither Agree nor Disagree	15.3%
Disagree	33.3%
Strongly Disagree	23.4%

**Table 5-6. Commander's Attitudes Toward DoD Outsourcing Policy**

**Respondents in a command position and have been involved in an outsourcing effort responding to the statement:  
DoD is headed in the right direction with respect to outsourcing issues**

Strongly Agree	3.9%
Agree	16.7%
Neither Agree nor Disagree	15.4%
Disagree	38.5%
Strongly Disagree	25.6%

**Table 5-7. Attitudes of Commanders Who Have Undergone Outsourcing**

headed in the right direction regarding outsourcing initiatives. Responses are depicted in Table 5-7.

While we are in no way stating that installation commanders are not executing outsourcing policy based on their personal assessments, it should be noted that they are concerned about these issues and their concern rises markedly after they have gone through the experience of outsourcing in its current form. At the very least, their feedback is worth gathering and assessing. While comments offered on a survey administered to a random sample of DoD personnel are not well suited for the type of broad feedback needed, we list some of the comments submitted by installation commanders.

- Military forces must always be EFFEC-TIVE on the battle[field] and we are building organizations that are designed to be most EFFICIENT [sic] during peacetime.
- The only outsourcing issue I have had personal experience with is A-76. It is a terrible process.

- I am not sure where DoD is heading quite frankly...and rules, regulations, etc. thus far have only made waters murkier.

- It appears as though few consider the broader strategic impact of changes done in isolated areas.

- I think we need to cut this BS out!

In his book *Leading Change*, John Kotter points out that one of the reasons that firms fail is that they do not create a sufficiently powerful guiding coalition.<sup>20</sup> If the change vehicle is the A-76 process, these data indicate that no coalition is possible, at least no majority coalition. Even for the 41 respondents who identified themselves to be in staff/policy positions, 53.7 percent disagreed or strongly disagreed DoD was headed in the right direction with respect to outsourcing. In our analysis we could find no one group where a majority of respondents strongly agreed or agreed with this statement. The closest category consisted of the ten respondents who identified their area of expertise as budget/finance. Of this group, 30 percent agreed DoD was headed in the right direction with respect to outsourcing. None in

this category strongly agreed with this statement.

### Implementing Strategy Through Levers of Control<sup>20</sup>

Belief systems represent only one of the moorings that secure an effective business strategy. We turn now to the other three levers of control introduced in Chapter Two. By way of review, they are boundary systems, interactive control systems, and diagnostic control systems. This model is depicted in Figure 5-2.

#### Boundary Systems

Boundary systems are mechanisms for letting firms manage strategic risk. They communicate specific risks to be avoided and take two forms: business conduct boundaries and strategic

boundaries.<sup>21</sup> Business conduct boundaries communicate clearly what behaviors are off limits. Bribing officials, colluding to fix prices, disclosing proprietary information are examples of typical conduct boundaries. These conduct boundaries are especially rigorous in DoD. Ethical standards are strict and well enforced. In DoD, even the appearance of misconduct will not be tolerated. This applies to both personal conduct and business conduct. Members of DoD, especially those of us in uniform, are held to a higher standard than the public at large. Indeed, DoD takes great pride in this higher standard. It is yet another factor that sets the Department apart and makes it unique.

While DoD does well in setting and enforcing business conduct boundaries, it is in the area of setting and enforcing strategic boundaries

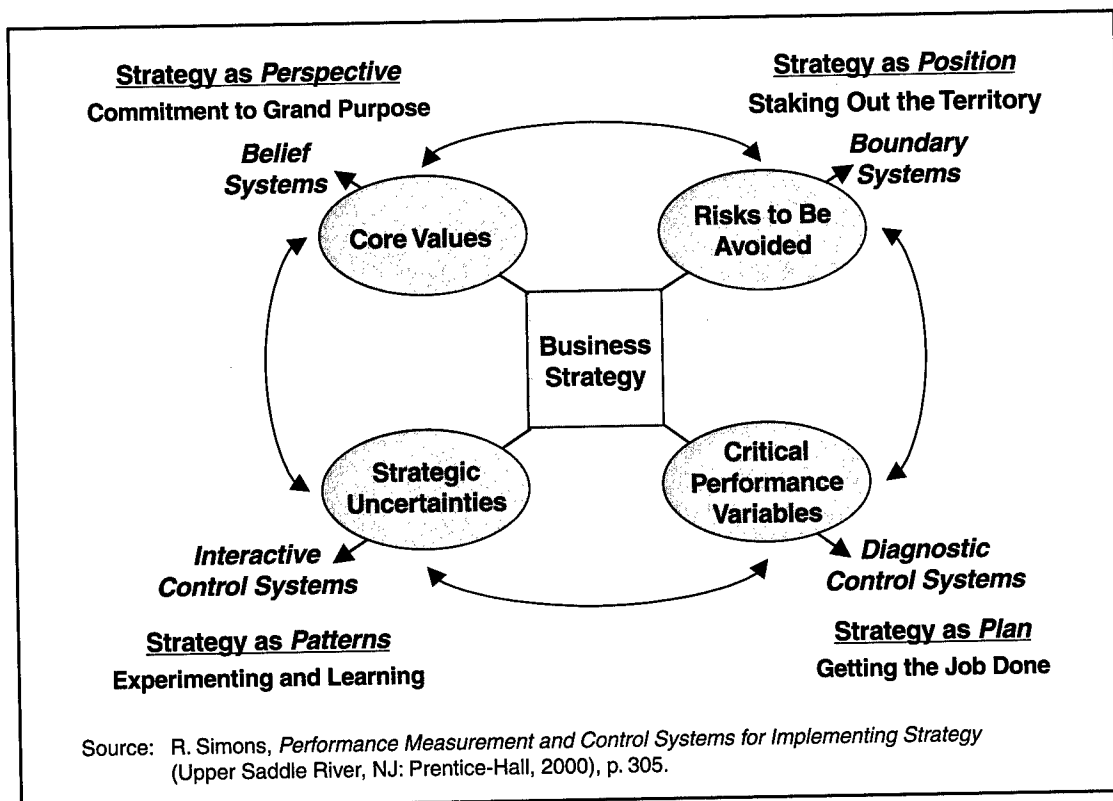


Figure 5-2. Levers of Control

that DoD has fallen short. Strategic boundaries are established to manage a different kind of risk — the risk of wasting scarce resources on initiatives that do not support the business's strategy.<sup>22</sup> Recall the mission of the DoD: to support and defend the Constitution of the United States; to provide for the common defense of the nation, its citizens, and its allies; and to protect and advance U.S. interests around the world. Now examine some of the activities DoD is engaged in.

- Photography
- Photographic processing
- Film and videotape production
- Art and graphics services
- Distribution of audiovisual materials
- Equipment installation, operation, and maintenance
- Vending machines
- Dietary services
- Veterinary services
- Machine, carpentry, electrical, plumbing, painting, and other shops
- Industrial gas production and recharging
- Equipment and instrument fabrication, repair, and calibration
- Plumbing, heating, electrical, and air conditioning services, including repair
- Custodial and janitorial services
- Trucking and hauling

- Office furniture and equipment
- Advertising and public relations services
- Library operations
- Stenographic recording and transcribing
- Mail/messenger
- Reproduction, copying, and duplication
- Landscaping, drainage, mowing, and care of grounds
- Guard and protective services
- Recreational areas
- Refuse collection and processing
- Laundry and dry cleaning
- Bus service

This is but a partial list of activities (cited in Attachment A) of the latest revision of A-76. They are cited as inherently commercial activities currently performed by government that should be subject to competition and outsourcing. This OMB Circular was first issued in 1966 but the underlying policy of not competing with the private sector goes back to 1955 and the Eisenhower administration.<sup>23</sup>

These activities, while important to the day-to-day functioning of the Department, do not lie within the strategic domain that is reflected in DoD's Strategic Plan. The activities cited above are critical to many businesses but that does not mean that they will perform the functions internally. Recall Kodak's decision in Chapter Two to outsource its data processing requirement. This was a critical function

to Kodak but one that did not fit within its strategic domain.

Why do companies set these boundaries? It is because activities in areas that do not lie within their strategic domain tend to distract attention from the core strengths and strategy of the business.<sup>24</sup> This is why Microsoft has expressly stated that it will not build hardware or enter the telecommunications business, even though these are profitable markets and Microsoft has sufficient resources to enter them. It is also the reason why Lee Iacocca, during Chrysler's dramatic turnaround, refocused the firm's resources on North American auto and truck manufacturing, declaring European, African, and non-automobile business off limits.<sup>25</sup>

Businesses know that there are many opportunities but only limited resources. Simons states the hard work of strategy is not deciding what to do; rather it is deciding *what not to do*.<sup>26</sup> To this end, firms generally have formal systems to analyze any new business venture that lies outside its strategic domain. This analysis goes beyond potential financial performance and establishment of a sustainable competitive position. It includes factors such as whether the distinctive competencies of the firm are suited to the new venture and whether entry into this market might result in an undesirable strategic position, such as the position in which Holland Sweetener found itself entering the aspartame market (see Chapter 2).<sup>27</sup>

One could either argue that DoD does not set strategic boundaries or that once set, they are not well enforced. Either way, the overwhelming predilection of the Department seems to be to integrate activities rather than to look to other outside sources. This is detrimental on two accounts. First it dilutes management attention and siphons off precious resources from activities that should represent DoD's strategic focus. Second, it means that many of these

activities, once integrated, are subject to outsourcing studies under A-76. This dilutes still more management attention and ties up additional resources. Better to have a strong boundary system from the outset than to compensate for it later.

### Diagnostic Control Systems

Simons states that diagnostic control systems are "the formal information systems that managers use to monitor organizational outcomes and correct deviations from preset standards of performance."<sup>28</sup> These information systems are used to set goals, measure outputs, compute performance variances, and provide feedback.<sup>29</sup> Performance evaluations are a good example of this. Individuals are notified of the grading standards, measured against performance of those standards in relation to other individuals, and given feedback via a periodic report.

The same diagnostic control systems are applied to business activities. Sales and profit goals are set, performance is measured, feedback is obtained, and any variance is analyzed. When these systems are aligned and integrated, individual effort contributes to the effective operation of the business. When these systems are not well aligned and integrated, confusion and uncertainty are generally the result.

In the business community, for many years these diagnostic control systems emphasized financial goals and performance. However, there is a growing realization that emphasizing financial performance alone may cause actions that are counterproductive to a firm's long-term strategy. Current business literature favors diagnostic control systems such as the Balanced Scorecard, which, as the name implies, seeks to strike a balance between financial measures and other perspectives such as the customer, business processes, and learning



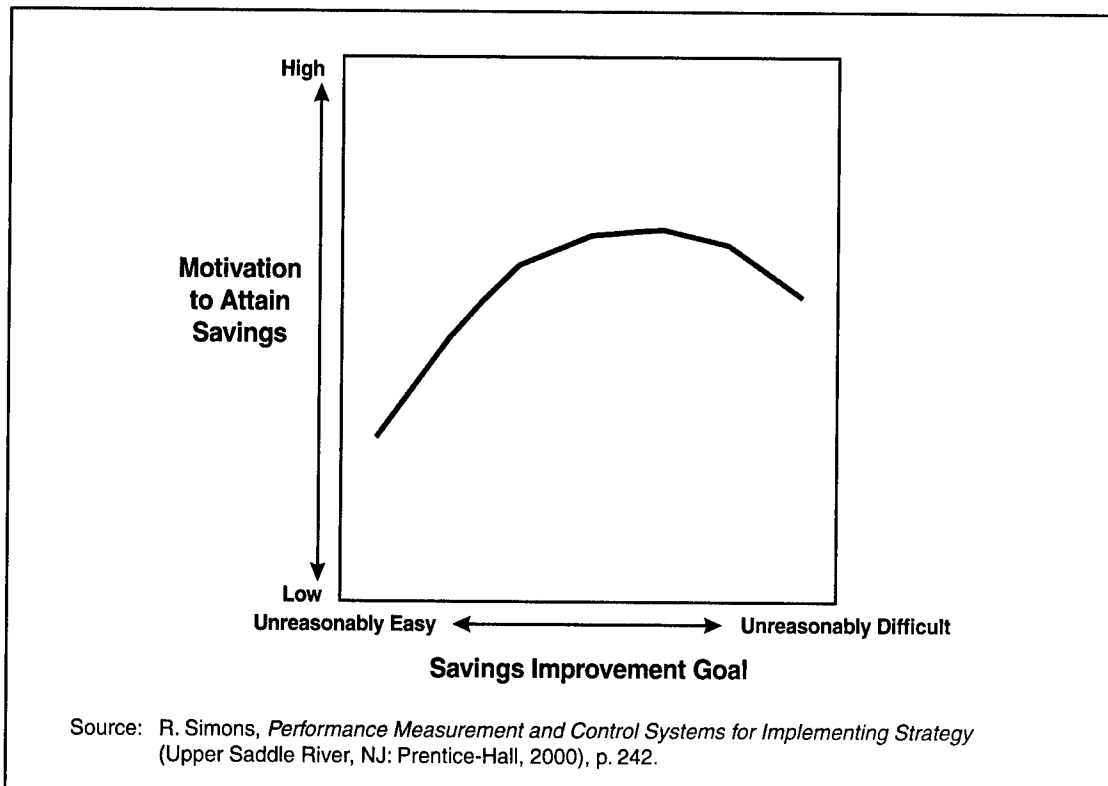
and growth.<sup>30</sup> These balanced criteria are then applied uniformly throughout the business.

It is this uniformity that is lacking in DoD. A quick scan of personnel evaluations used by the military show that individuals are graded on criteria such as mission accomplishment, teamwork, equal opportunity, and leadership. Individual units are graded primarily on mission accomplishment. However, continuing up the hierarchy, these effectiveness measures are eclipsed by financial efficiency measures such as the savings targets discussed earlier.

Furthermore, these measures are not subject to rigorous feedback in the form of variance analysis nor are the inputs adjusted. These financial goals, especially the savings targets associated with A-76 and competitive sourcing, tend to become “must achieve” goals rather than “can

achieve” goals. This is often the difference between reasonable, achievable goals and unreasonable, unachievable goals. While goals should be challenging, they should not be unobtainable. Beyond a certain point, people tend to see the goal as either impossible or not worth the effort. This tends to lower rather than raise motivation.<sup>31</sup> This tendency is depicted in Figure 5-3.

Recall DoD’s competitive sourcing goal, which projects cumulative savings of \$11.7 billion through fiscal year 2005 and then \$3.5 billion annually thereafter.<sup>32</sup> This and past iterations of this goal have been cited by the GAO as being unrealistic.<sup>33</sup> Survey results indicate that personnel in DoD share this view. The level of frustration and dissatisfaction expressed in their responses leads us to believe that motivation to achieve cost savings is tailing off.



**Figure 5-3. Relationship between Motivation and Goal Difficulty**

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## **Interactive Control Systems**

These are the control systems that allow managers to view the strategic landscape over the horizon. These systems communicate strategic uncertainty and convey it to corporate leadership. These are the systems that show management what lies ahead in the strategic path that could cause the strategy to fail.<sup>34</sup>

Interactive control systems go beyond budget and operating plans and are not standardized like a financial report. They vary from company to company but they have four defining characteristics.

1. Information generated by the system is an important and recurring agenda addressed by the highest levels of management.
2. The interactive control system demands frequent and regular attention from operating managers at all levels of the organization.
3. Data generated by the system are interpreted and discussed in face-to-face meetings of superiors, subordinates, and peers.
4. The system is a catalyst for the continual challenge and debate of underlying data, assumptions, and action plans. It is a mechanism for enabling the organization to learn and adapt.<sup>35</sup>

As we saw in Chapter One, new technologies may undermine a company's strategic position, so too could demographic changes, the entry of a competitor, or government regulation.<sup>36</sup> Senior management must be ever vigilant of the competitive landscape and position their business or businesses accordingly. Interactive control systems may take the form of market research data that would have shown Henry Ford that consumers were coming to see cars as a measure of affluence and that they craved

variety over price. Interactive control systems may take the form of technical reports that would have shown the integrated steel mills that mini-mill technology was improving to the point that it would one day be capable of producing sheet steel. Interactive control systems may take the form of value chain analysis that would have shown Radio Corporation of America (RCA) that, despite its preeminence in research and development (R&D), it did not have the requisite marketing, sales, service, or logistics structure to take on IBM in the computer industry.

From the perspective of DoD, operational elements rely heavily on such interactive control systems. The Department conducts war games, strategic reviews, and battle exercises designed to show vulnerabilities in wartime strategies. Unfortunately and somewhat ironically, DoD's business functions invest precious few resources in such systems. Instead of being proactive, the Department is often in a reactive mode. Planning horizons are relatively short (generally one funding cycle out) and problems are generally dealt with as they occur instead of before the underlying issue becomes problematic. Many of the DoD briefings and presentations we have viewed in the course of this research use phrases such as "we should have seen this coming," or "this was a train wreck just waiting to happen." Establishing better interactive control systems might preclude or at the very least minimize incidents that cause such statements to be made.

## **Compliance and Execution Incentives**

DoD, perhaps more than any other agency, expects compliance throughout the chain of command. However, compliance can be swift and determined or it can be slow and grudging. Business leaders understand this. They are organized for performance taking great care to establish in their work units the appropriate

incentives and the requisite span of control and accountability.<sup>37</sup>

In both a business and a military context, span of control denotes how many and which subordinates and functions report to each manager in the organization.<sup>38</sup> This relationship is depicted in the organizational chart. These charts are remarkably similar for both business and industry primarily because traditional hierarchical business structures were patterned after military structures. Within these spans of control are spans of accountability.

### **Spans of Accountability and the Profit Motive**

Spans of accountability describe the range of performance measures used to evaluate a manager's achievements.<sup>39</sup> In business, these measures at some point take into account specific financial measures such as sales, inventory and, most important of all, profit.

Profit in its essence measures the return generated on assets committed to an activity. This is a powerful measure and a powerful motivation. Profit accountability indicates that the manager is accountable for costs, revenues and, often, assets. Profit center managers must make trade-offs between costs and revenues.<sup>40</sup> This becomes the mechanism that tends to drive efficiency once an effective strategy is devised. In fact, it is such a powerful force that it must be balanced so that gains in short-term efficiencies do not erode long-term strategic advantage.<sup>41</sup>

Public sector agencies, on the other hand, do not exist to earn a profit. Absent this profit motive, an important impetus to generate efficiencies is also removed. In the calls to have DoD act in a more business-like manner, one should always keep in mind that in the business world, the profit motive drives firms to be

efficient within their business strategies. Absent this, the playing field differs significantly.

One should also be wary of statements that assert government services are a bargain because the government does not earn a profit. In fact, large-scale studies show that prices charged by profit making contractors are substantially lower, on average, than the cost of non-profit government work.<sup>42</sup> Competitive forces of the marketplace weed out first the ineffective, then the inefficient. These forces account for cost disciplines that more than compensate for any lack of margin.

### **Cost Center Accountability**

Public (non-profit) agencies largely follow a model of cost center accountability. This means that managers are given a budget and asked to deliver the desired level of goods or services within those spending constraints. Cost managers need only monitor specific expense lines.<sup>43</sup> Furthermore, these expense lines are generally limited. Installation commanders, for example, are not generally accountable for expenses associated with salary, capital investment, or inventory obsolescence. Their span of control does not cover these areas. This is primarily a result of the high degree of compartmentalization associated with government accounting. Salaries are paid from one account, capital equipment with another, issue of initial supply stocks with a third, and replenishment of supplies with a fourth. This is done to ensure that funds are spent as they are intended to be, but it also limits the degree of control managers can exercise and it precludes making many trade-offs.

DoD activities operating under working fund accounts have a wider span of accountability. Commanders of these activities are accountable for salaries, inventory obsolescence, and a wide range of other expenses, but there are

still limits to the degree of autonomy they can exercise. Working fund managers are tasked with using these assets to generate a range of services and charging for them only to the extent they can break even. Furthermore, law or regulation generally protects these activities so that they have a captive group of customers that must buy from them — primarily the operating forces they serve.

### **Impetus to Generate Savings**

Operating cost or break even centers means that any savings generated through outsourcing or any other initiative by and large are not available for the installation commander or working capital fund manager to reinvest or realize as profit. The money is swept up and used to fund activities outside their span of control. In fact the system is set up such that those that generate the most savings lose the most while those that generate the least savings retain the most.

Absent a natural enticement toward greater efficiency, DoD, with congressional oversight, established savings goals and created a commensurate funding shortfall. Each of the Services was given individual savings targets to be met on an annual basis. Progress on meeting these targets is reported to Congress and scored by various agencies including the GAO. The mechanism for attaining these savings targets is public-private competitions using the A-76 process.<sup>44</sup>

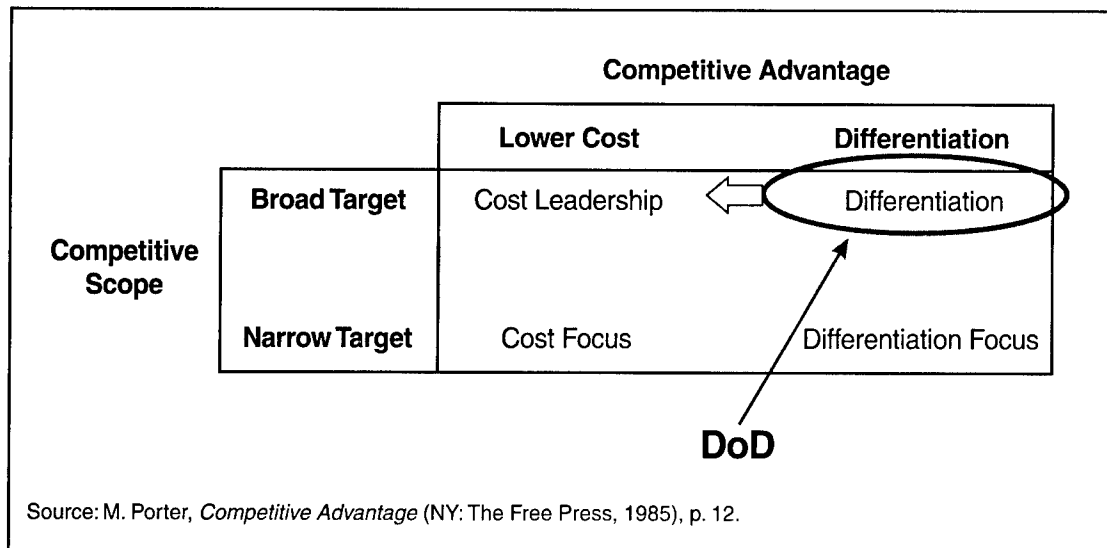
However, as was indicated in Chapter Four, despite the aggressive targets and equally aggressive enforcement of A-76 competitions, the results have still fallen below expectations. In an effort to rely more on the carrot and less on the stick, the Bush Administration recently announced that it would push to let agencies retain savings garnered from public-private competitions.<sup>45</sup>

We are skeptical as to whether this will prove an effective mechanism. Agency retention is not the same thing as retention by the affected activity where economic incentives would have the most impact. However, even if savings were retained at the activity level, it is doubtful that a cost-driven outsourcing strategy will be embraced. As discussed previously, DoD personnel place mission accomplishment and the welfare of Department personnel ahead of savings goals. This is particularly true of base and installation commanders. It shouldn't be surprising. Mission effectiveness is what DoD's belief system emphasizes and on what they are graded. This defines their span of accountability.

### **Strategy or Execution Failure?**

The simple answer to this question is "yes." Everything we have described about the Department's belief system, vision, and mission point clearly toward a strategy of differentiation. Yet, as we saw in Chapter Four, the crux of A-76, strategic sourcing, competitive sourcing, and many of the Defense Reform Initiatives, is cost savings — pulling DoD away from a differentiation strategy toward a cost leadership strategy. This is depicted in Figure 5-4. Unfortunately without the requisite changes in the belief system, vision, etc., this can only serve to leave us in the "gray zone" — the equivalent of "no man's land" on the tennis court between the service and end lines where you are at the mercy of your opponent.

Given the emphasis on cost, we are also seeing execution problems as we try to implement the various Revolution in Business Affairs initiatives. Recalling Table 2-3 from Chapter Two on the likely outcomes of operating the levers of control independently or without any one of them, we can see the source of the problems. In Table 5-8 we have highlighted some of the outcomes that were borne out in our survey.



**Figure 5-4. Three Generic Strategies**

The lesson is quite clear. You cannot change corporate strategy independent from major changes in the organization.

### Transformation Urgency

In much the same way the body's immune system responds to repel a foreign organism,

Belief Systems (Values, Norms)	Boundary Systems (Decision Rights)	Diagnostic Control Systems (Metrics, Rewards)	Interactive Control Systems (Knowledge Flows)	Outcomes
No	Yes	Yes	Yes	<ul style="list-style-type: none"> <li>– Misconduct</li> <li>– Low Inspiration</li> <li>– Poor Teamwork</li> </ul>
Yes	No	Yes	Yes	<ul style="list-style-type: none"> <li>– Uncertainty</li> <li>– Power Struggles</li> <li>– Indecision</li> <li>– Inconsistency</li> </ul>
Yes	Yes	No	Yes	<ul style="list-style-type: none"> <li>– Low Motivation</li> <li>– Passive, Slow Pace</li> <li>– Unclear Purpose</li> </ul>
Yes	Yes	Yes	No	<ul style="list-style-type: none"> <li>– Poor Decisions</li> <li>– Strategic Surprises</li> <li>– Poor Coordination</li> <li>– Low Learning</li> </ul>

Source: Adapted from summary class notes, T. Piper, "Achieving Profit Goals and Strategies," *Corporate Financial Management*, Program for Management Development, PMD75, Harvard Business School.

**Table 5-8. Organizational Outcomes**

DoD has responded to cost-based outsourcing. Just as the immune system does not recognize the foreign body, DoD does not recognize a foreign strategy. But this is not to say that all outsourcing initiatives will be rejected or that DoD is content with business as usual. In fact, there is a strong sense that transformation does need to occur and that business as usual is unacceptable. In our survey we asked the following question regarding the need for change:

Need exists for significant improvement in the way DoD and the departments/agencies conduct business operations (commercial-like activities).

Yes      No

Of the 232 who responded to this question, 86.6 percent responded "Yes." This is a strong indication that the sense of urgency is shared sufficiently across DoD. For the 111 respondents that identified themselves as being in a command position, the percentage responding yes to this question rose to 91 percent.

In his book *John P. Kotter on What Leaders Really Do*, Kotter examines the role of leadership in bringing about change in an organization. He lists some common mistakes made by senior leaders that prevent an organization from making a successful transformation. Error number one is not establishing a great enough sense of urgency. Based on his own experiences, Kotter believes the urgency rate is sufficient to effect change when about 75 percent of an organization's management is convinced that "business-as-usual is totally unacceptable."<sup>46</sup>

Using Kotter's figure as a benchmark, it seems that the stage is set for some kind of a transformation in the way DoD operates its business functions, based on our limited survey results. Just as beliefs can be harnessed, so too can

this sense of urgency. In the next chapter we will examine potential ways to channel this energy to transform DoD in ways that are commensurate with the Department's strategy.

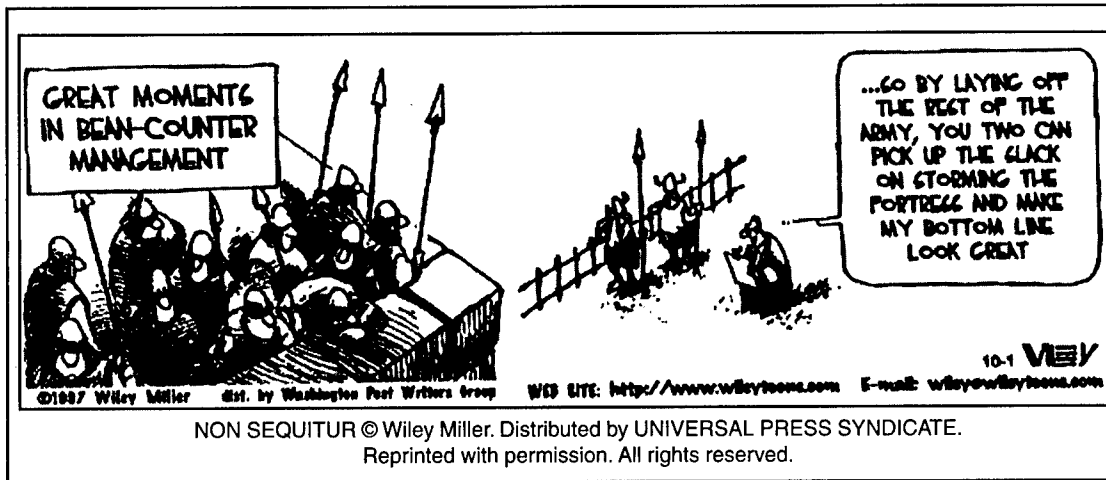
## Summary

In this chapter we used strategic tools and concepts introduced in previous chapters to build an analytical framework with which to examine DoD. This began with an analysis of the beliefs, vision, and mission. DoD has a strong and enduring set of beliefs, its vision is well crafted, and its mission is well aligned. This structure denotes an organization pursuing a strategy of differentiation. This is at odds with A-76 and other cost-based outsourcing initiatives, which are more aligned to a strategy of cost leadership.

The structures that anchor strategy are the levers of control consisting of belief systems, boundary systems, diagnostic control systems, and interactive control systems. While DoD has strong belief systems, the other three levers are wanting or misaligned. These inequities lead to predicted outcomes that are reflected in the survey we administered to a random sample of DoD personnel.

Further complicating current outsourcing strategies is the financial structure of DoD, which mitigates any economic incentive an installation commander might have to aggressively implement a cost-based outsourcing strategy. However, even if economic incentives were better aligned to achieve the desired result of cost savings, belief systems and underlying strategy would likely obviate a better incentive structure.

Finally, uniformly negative attitudes toward DoD outsourcing policy doesn't mean that personnel within the Department do not see a need for changing business practices. In fact,



over 85 percent of 234 survey respondents are dissatisfied with business as usual. There is potential for a critical mass of people within the organization who share this sense of urgency to drive change.

In Chapter Six we will explore the benefits of a new corporate strategy approach and whether such an approach can be implemented. This approach is constructed to fit within both the differentiation strategy for which DoD is suited as well as the practical realities of DoD's operating environment.

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# 6

## DOD CORPORATE STRATEGY AND OUTSOURCING

*“We must put strategy first, then spending. Our defense vision will drive our defense budget, not the other way around.”*

— President George W. Bush

### Introduction

Until now, we have compared Department of Defense (DoD) outsourcing results to the private sector's outsourcing experience. We have also examined whether DoD's diminished performance results from a failure in strategy formulation, strategy execution, or both. Finally, we have addressed the question of urgency: is there a real urgency and if so, is that sense of urgency shared adequately across DoD in order to effect change?

The need for change is evident. Yet why has change been slow to fruition? As we noted in the previous chapter, the Office of Management and Budget (OMB) Circular A-76 (A-76) and strategic sourcing initiatives are at odds with DoD's generic corporate strategy of differentiation. This is the cause for inconsistent actions that diminish the competitive advantage DoD has worked hard to obtain. In addition to

the problems caused by the pursuit of multiple strategies, the levers of control for executing strategy are lacking on three counts. First, they do not dictate firm strategic boundaries. These boundaries are essential to setting DoD strategic domain — what functions it will operate, what it will outsource — and establishing where decision rights reside between the corporate, Office of the Secretary of Defense (OSD) level, and the Service level. Second, diagnostic control systems are not aligned. Effectiveness is measured and rewarded at the unit level where A-76 is executed, while economics is emphasized at the headquarters or staff level where A-76 is not executed. Last, interactive control systems, which would enable leadership to identify strategic uncertainties, are woefully missing — a point that is even more remarkable given an organization that extensively uses interactive planning systems daily in its warfighting element.

In this chapter, we will formulate a model for DoD corporate strategy and outline the methodology for making effective outsourcing decisions commensurate with that model. We will also describe the required levers of control to monitor strategy execution effectively and bring about change. Chapter Seven will follow with recommended actions to remedy the situation and set the stage for transformation.

### DoD Corporate Strategy

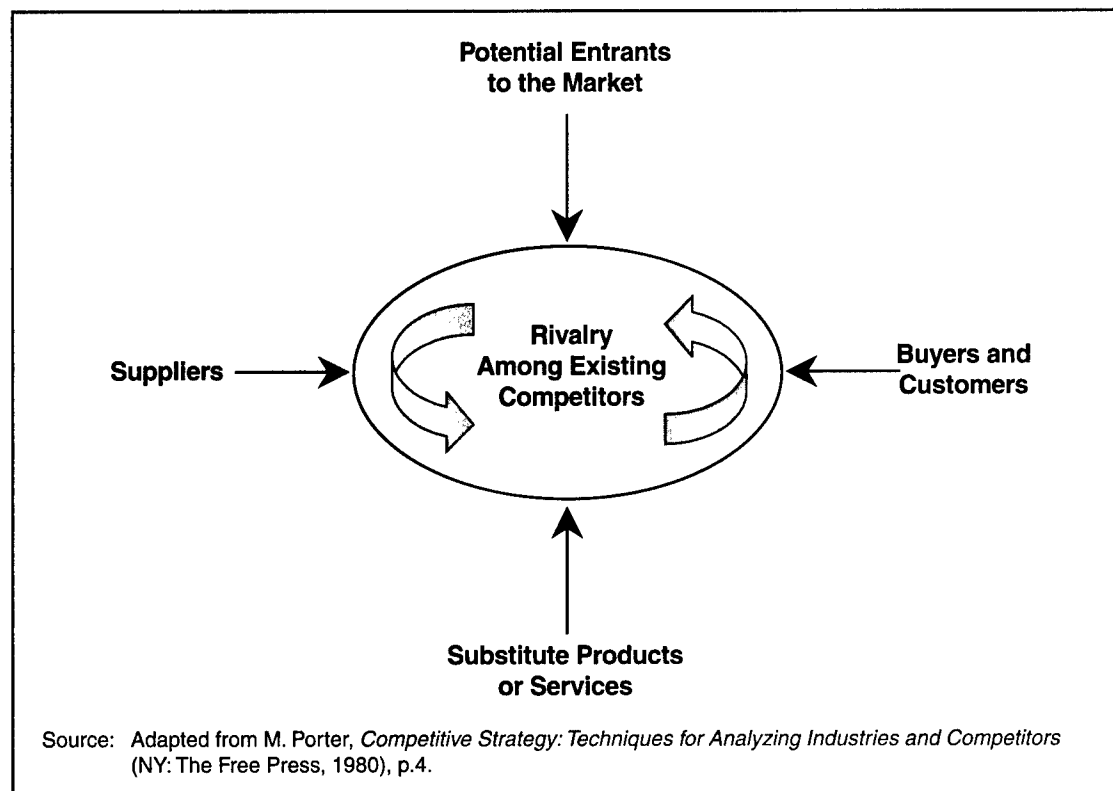
To develop strategy, one must understand the competitive environment. To do this businesses conduct strategic analyses. In Chapter Two, we introduced several tools for analyzing strategy. In this section, we turn to one of those tools, Five Forces Analysis, to gauge the competitive landscape facing DoD at the beginning of the 21st century.

### Five Forces Analysis

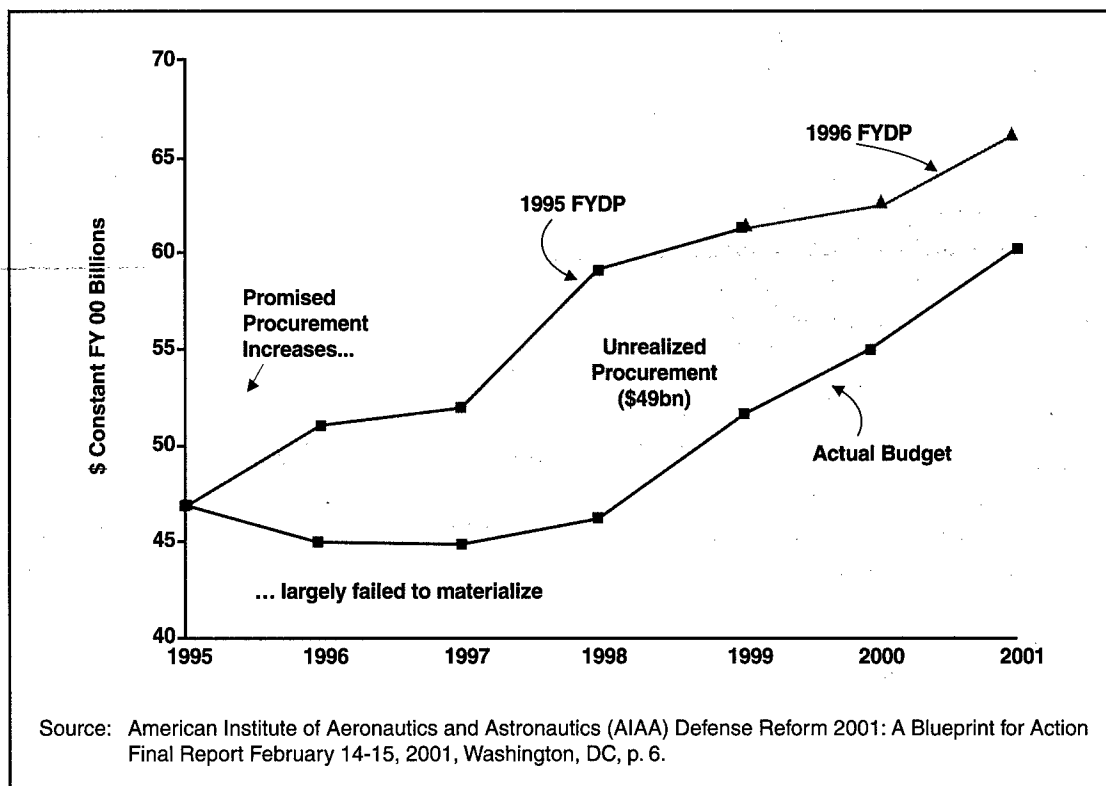
Figure 6-1 shows the framework for Five Forces Analysis. These forces consist of suppliers, potential entrants to the market, buyers and customers, substitute products or services, and rivalry among existing competitors. What follows is an analysis of DoD business functions within the framework of these forces, beginning with the horizontal axis and concluding with the vertical axis.

### Suppliers

As we saw in Chapter One, the Defense Industry has suffered in the post-Cold War era. The downsizing of the military force structure and military budgets brought about a series of mergers and acquisitions that resulted in a massive consolidation. Thirty-two major defense



**Figure 6-1. Five Forces Analysis**



**Figure 6-2. Planned vs. Actual Procurement Spending  
(Fiscal Years 1995-1999)**

contractors have consolidated into seven.<sup>1</sup> For those remaining, procurement spending has been cut nearly in half.<sup>2</sup> Smaller budgets have meant greater competition for smaller production runs and fewer new starts.<sup>3</sup> Compounding this is the unpredictability of annual procurement spending. Figure 6-2 shows the shortfall in planned versus actual procurement spending since 1995.

While the Defense Industry has suffered, other areas of the economy have prospered. Despite recent market setbacks, the high technology Information Economy segments have flourished. Over the past five to ten years, these new economy industries have consistently outperformed the Defense Industry. Furthermore, earnings in the Defense Industry pale in comparison to earnings offered by the technology

sectors. In 1999 the key defense companies average margins were 4.3 percent compared with margins ranging from 20 to 40 percent attained by commercial high technology companies.<sup>4</sup> While investors are willing to take on high-risk for high-return, they are generally not willing to enter into the high-risk, low-return world of modern defense. The instability of defense programs, compounded with the relative attractiveness of other markets, has worked to drive investor capital out of the Defense Industry. This is reflected by the flat performance of defense stocks in relation to other industries.

Compounding this is the leveraged position of the industry. Debt loads have increased as a result of consolidation.<sup>5</sup> Unfortunately, these firms were taking on debt at the same time that their earnings and attractiveness to

investors was sliding. Decreased performance has translated into lower bond ratings, an increased cost to borrow, and an increased cost of capital. In some instances the cost of borrowing capital has exceeded the companies' rate of return.<sup>6</sup>

All of this has an impact on the industry, on DoD, and on the security of this great nation. The price DoD pays for its products and services reflects the cost of providing them plus a fair and reasonable profit. As the cost of capital increases so too does the price the Department pays. While DoD has long benefited from a robust Defense Industry, arguably the industry is no longer robust. In fact, Harry Stonecipher, President and Chief Operating Officer of The Boeing Company, referred to the industry as a "no growth business."<sup>7</sup> At the end of the 1990s there were only a handful of industries that fell below the Defense Industry's average rate of return. These industries included shoe manufacturing and groceries.<sup>8</sup> When formulating its corporate strategy, DoD must take into account the health of the industrial base — our major supplier.

### **Buyers and Customers**

In keeping with DoD's vision and mission, we place operational forces in this category. Support activities within the Department by and large exist to provide products and services to the unified commanders and the warfighting elements under their command. Operational forces then work to fulfill the mission of DoD as outlined in the mission statement. This is an important distinction. Each DoD support element occupies a specific place in the value chain. Support activities serve primary activities. Primary activities then support the ultimate buyer and customer: the nation and its citizens.

The next question is what do operational forces value? There are likely segments that place a

premium on price, whether acquisition cost or life cycle cost. Others prefer availability or speed of delivery to cost. Still others might be willing to pay a premium acquisition cost for a higher level of quality and the expectation of a lower life cycle cost. Mobil, as we saw, was able to discern buyer segments where it could compete on a basis other than price. DoD agencies and the Services could use the same techniques to discern where it could provide products and services that are differentiated in a way that might appeal to the type of product or service valued by the end user.

### **Potential Entrants to the Market**

Government agencies have at their disposal a subtle but effective barrier to entry. They can merely refuse to let the commercial sector compete for their business. By statute or regulation, agencies can be limited to obtaining products or services from within the government, or outside providers may be allowed in — only under very strict conditions. Conversely, a commercial firm cannot dictate competition unless it is willing to risk litigation. The government can in effect create a monopoly.

Government monopolies are established for a number of reasons. For example, the activity may provide products or services that by their nature are monopolies, or overlapping agencies may be combined leaving the surviving agency with monopoly status.<sup>9</sup> Regardless of the reason, government monopolies share two characteristics. First, absent competition and the market discipline that results from competition, agencies tend to become less effective and less efficient over time. Second, once established, government agencies are rarely disestablished. In fact, they tend to grow.<sup>10</sup>

While this barrier to entry helps to rationalize some business elements of DoD, it also works to foster an element of complacency. Absent

the threat of bankruptcy, organizations can squander resources or run deficits for extended periods of time. Absent competition, individual comparisons, preferences, and the resulting value assessments are masked. And absent market incentives, no individual financial performance incentives are tied to return on resources (i.e., profit).<sup>11</sup>

For both business and government, any barrier to entry is a double-edged sword. It allows an organization to secure a position in the market but it also tends to stifle performance and, over time, reduce its ability to react when a new player exposes and exploits vulnerability. Barriers to entry may be breached by new technology, new customer preferences, or by changes to law and regulation. Firms should always question whether, absent the barrier to entry, it can compete effectively. The same applies to government agencies.

DoD must recognize that the commercial sector is not only a potential new entrant, but as we learned from Adam Brandenburger and Barry Nalebuff's book, *Co-opetition*, they are also potential partners. As we discuss next, the commercial sector has valuable resources that can complement the Department's resources thereby creating more value for its customer, the warfighter.

### **Substitute Products or Services**

Substitutes were historically something DoD support activities did not have to worry about. Fifty years ago, who else but the military could boast of capabilities that could support operations worldwide, 24 hours a day, seven days a week? Today, many companies support ongoing worldwide operations rivaling the scope of DoD. Forty years ago, DoD and its defense contractors were the undisputed leaders in cutting-edge technology. Today, much of DoD technology lags behind what is available commercially.

Thirty years ago, DoD developed ground-breaking technology for routing information and used this technology to launch a communications network.<sup>12</sup> Today, this technology powers the Internet and DoD is racing to exploit this commercially available potential.

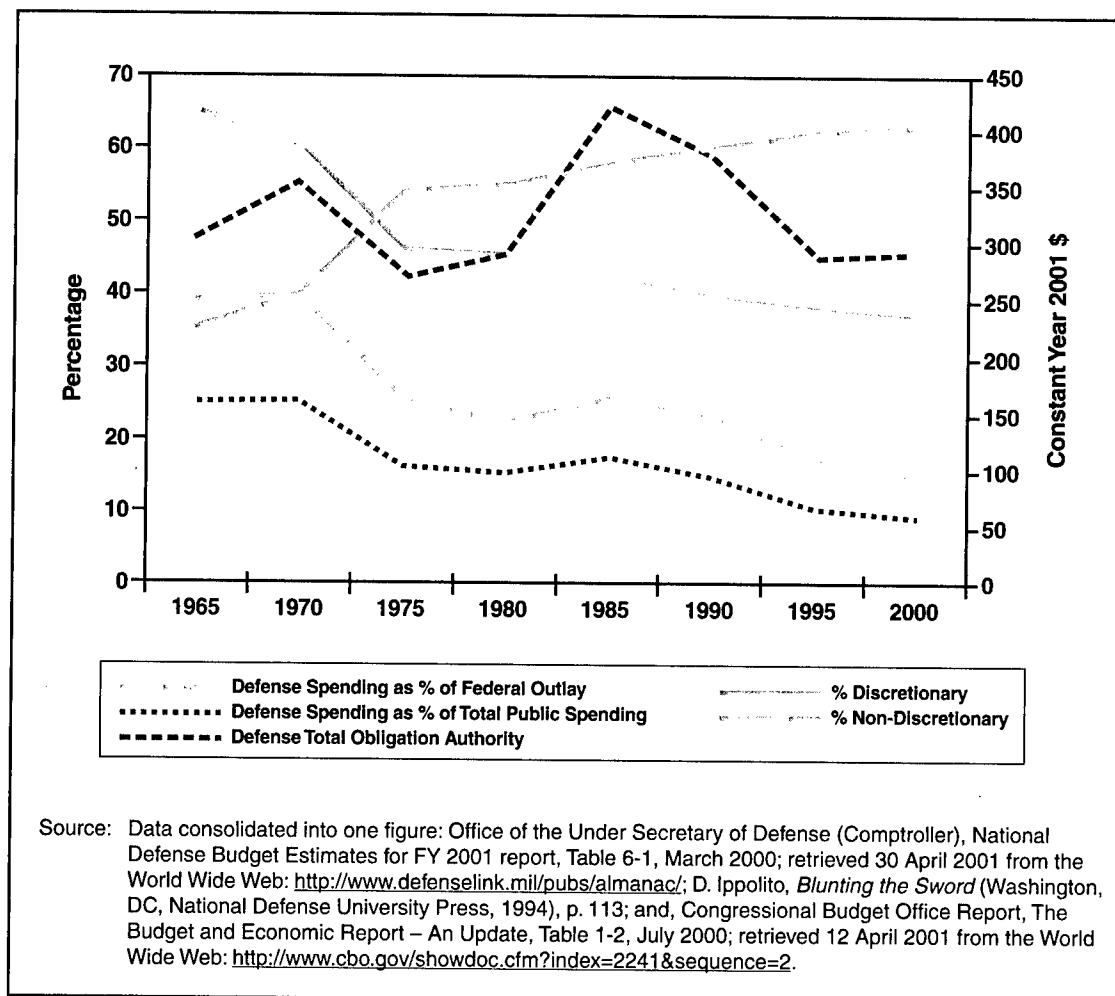
Today, DoD is coming to grips with the fact that the commercial sector is now able to provide products and services that are on par with or better than what DoD can provide internally. In many cases, this means these products and services can be readily substituted for what the government has traditionally provided.

### **Rivalry among Existing Competitors**

Government agencies, like DoD, do not compete for market share but they do compete for resources among other federal agencies, like the Department of Energy, and within themselves. We saw earlier that defense spending is down significantly over the past decade. Defense spending as a percentage of total federal outlays and as a total of net public spending is steadily declining (see Figure 6-3).

This trend has become more pronounced over time. In 1965, DoD spending represented 38.8 percent of federal outlays and 25.2 percent of net public spending. By 1975, these figures were down to 25.5 percent and 16.5 percent, respectively. Ten years later, at the height of the Reagan Administration defense build up, both figures remained roughly at the same 1975 levels. Yet, by 2000, these figures had declined to 14.8 percent and 9.1 percent, respectively.<sup>13</sup>

This is not to say defense spending has been declining during the same period (1965-2000). In fact, it has remained relatively constant at approximately \$300 billion (in Constant Year 2001 dollars), except for two spikes coinciding with the end of the Vietnam War in 1970 and at the height of the Reagan Administration



**Figure 6-3. Decline in Federal Discretionary Budget Spending**

build up in 1985.<sup>14</sup> This lends some credence to the arguments that an increase to the top-line defense budget authority is unlikely — absent a major conflict or dramatic change in overall national security or military strategy. If, from 1965 to 2000, defense outlays are constant at around \$300 billion, how then could defense spending fall in relation to total federal outlays?

The answer is that total federal spending has increased at a faster pace. In particular, non-discretionary spending has increased dramatically. This category of spending includes

entitlement programs such as Medicare, social welfare programs, and payment on the national debt. Unlike discretionary spending, these accounts are not part of the annual Congressional appropriations process. These accounts pay automatically and their growth is squeezing discretionary accounts, like defense, that are subject to annual appropriations. In 1965, discretionary spending accounted for 35 percent of federal outlays. By 1990, it had risen to 60 percent of federal outlays.<sup>15</sup> This figure is projected to reach 63 percent in 2000 and rise to 74 percent by 2010.<sup>16</sup> Federal agencies will continue to fight for a dwindling slice of

discretionary dollars and, as the slice of defense spending declines, the battle then carries over to an internal struggle within DoD. Without significant change, this rivalry is likely to intensify.

The Department currently resides in the business landscape summarized in Figure 6-4. From this analysis we can develop an effective corporate strategy for DoD.

### Formulating a DoD Corporate Strategy

As we relayed in Chapter Three, Michael Porter describes three generic strategies firms can pursue: cost leadership, differentiation, or focus. A firm may derive competitive advantage from having the lower-cost product or service at an equivalent quality or a differentiated product or service at a reasonable price relative to its competitors. In addition, scope is a critical component of competitiveness. A firm can seek

to market to a broad target or a narrow one. This is illustrated in Figure 6-5.

For DoD, the competitive scope is clearly a broad one. The Department must provide the people, equipment, and training to a very broad range of customers who are engaged in a full spectrum of military operations. This rules out pursuing a narrow cost-focused or differentiation-focused strategy, leaving DoD to determine whether competitive advantage can best be obtained by being a cost leader or through differentiation.

Arguably, DoD has been a differentiator for some time now. The Department, its various agencies, and the Services have aimed to recruit the *best* people and provide them with the *best* equipment and training. This was especially true after DoD went to an all-volunteer force in the 1970s and during the Reagan Administration build up of the 1980s. This

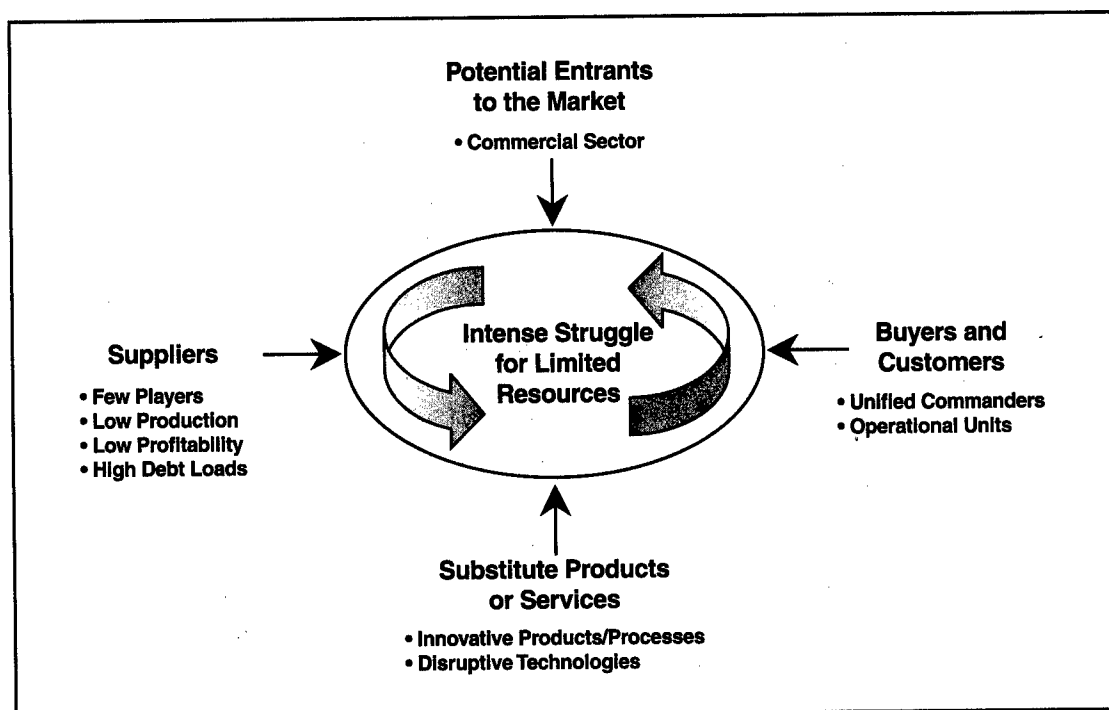


Figure 6-4. Five Forces Analysis of DoD



		Competitive Advantage	
		Lower Cost	Differentiation
Competitive Scope	Broad Target	Cost Leadership	Differentiation
	Narrow Target	Cost Focus	Differentiation Focus

Source: M. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (NY: The Free Press, 1985), p. 12.

**Figure 6-5. Generic Strategies**

strategy paid immense dividends as evidenced by the remarkable operational achievements during Desert Shield/Desert Storm and the Kosovo Operation. Yet DoD is faced with the need to maintain readiness and fund an extensive modernization program under the umbrella of limited resources. The question is, should DoD now adopt a cost leadership strategy and completely restructure in line with this new strategy or should it continue to pursue a differentiation strategy and develop the proper processes to make this strategy successful?

The Department's mission and analysis suggest that DoD should continue to pursue differentiation for several reasons. First and foremost, DoD's corporate strategy is itself a strategy subordinate to the National Security Strategy (NSS) and National Military Strategy (NMS). As a result, the corporate strategy must align with the goals of the NSS and NMS. As long as these goals continue to emphasize *engage, shape, respond*, and *prepare*, DoD cannot pursue a cost leadership strategy.<sup>17</sup> According to Michael Porter, a successful cost leadership strategy depends on products or services that are on par with competitor offerings in terms of quality.<sup>18</sup> Having equipment and services that are merely *on par* with any potential

U.S. enemy is clearly not a formula for success. This nation's continued security demands a defense force that is unequalled in capability.

Second, DoD's customers — the warfighters — still value and demand a differentiated product or service. In order to execute their mission and exploit enemy vulnerabilities they need the best. Nonetheless, cost is certainly a critical aspect of the warfighters' requirement. Even the differentiator cannot ignore costs. As Porter states, "A differentiator thus aims at cost *parity* or *proximity* relative to its competitors, by reducing cost in all areas that do not affect differentiation."<sup>19</sup> Successful commercial firms that aim at differentiation are doing this.

Finally, DoD must have a viable supplier base to properly equip the warfighter. Given an industry that is already suffering, a cost leadership strategy runs the risk of squeezing even more out of the suppliers. In the end this could drive more suppliers away from government business or the balance of power may shift to the suppliers with the unintended consequence of driving up procurement cost, resulting in DoD paying unreasonably high prices for on-par products or services.

If, as this suggests, DoD should continue to rely on a differentiation strategy, what then explains the dire straits it is currently in? Going back to the analysis above, several items leap out. As we said, government agencies like DoD can simply create a monopoly. The dangers of this are complacency, inefficiency, and reduced ability to react.

One way of creating that monopoly is to vertically integrate. However, those pursuing a differentiation strategy should avoid integrating into areas that might dilute the value of its brand and products. In the past, DoD may have been correct to integrate into various operations in order to capture what Porter terms the economies of combined operations or economies of information.<sup>20</sup> Combined operations produced such efficiencies as reduced transportation costs. At the same time, integrated operations reduced the need to capture some types of information vital to the process. Through vertical integration, DoD captured the benefit of coordination and control to facilitate massive, worldwide operations required at the time. Yet the costs of vertical integration born by DoD are those typical of the traditional hierarchical organization:

- Weaker incentives;
- Bureaucracy; and
- Inflexibility due to the commitments in capital and resources.<sup>21</sup>

However, today's Information Economy enables virtual organizations to capture and use information far more effectively than was the case in the past. The earlier Cisco discussion clearly illustrates this point. Cisco has complete coordination and control of its processes even under its virtual corporation model because it has the critical information to make sound decisions without the burden of owning all the assets. Information technology is rapidly diminishing the importance of organizational boundaries. The Department has been slow to react to this change.

An additional symptom apparent today in DoD is a diluting of brand image. Those critical factors that make the United States Armed Forces the best in the history of the world are suffering today. First, DoD is experiencing difficulty recruiting and retaining the best people, and second, the equipment is aging. Without the best people, the best equipment, and the best training, readiness will suffer.

As stated in Chapter Three, firms that differentiate take great care to build, cultivate, and reinforce a strong brand image. However, the Services have suffered from recruiting shortfalls and retention problems. The booming economy of the 1990s certainly contributed to the problem, but nonetheless, DoD is suffering from what marketers would call brand erosion. The Army has gone so far as dropping the second most memorable slogan of the century according to Advertising Age.<sup>22</sup> The "Army

*"What I do know is that savings tend to come later, not earlier; that is, for example, when you have to do things to rearrange yourself so you can save some money, you tend not to get the benefit of that — whether it's a company or a department of government — you don't get the benefit of that the first year. It tends to come in the second or third or fourth year."*

Secretary of Defense Donald Rumsfeld

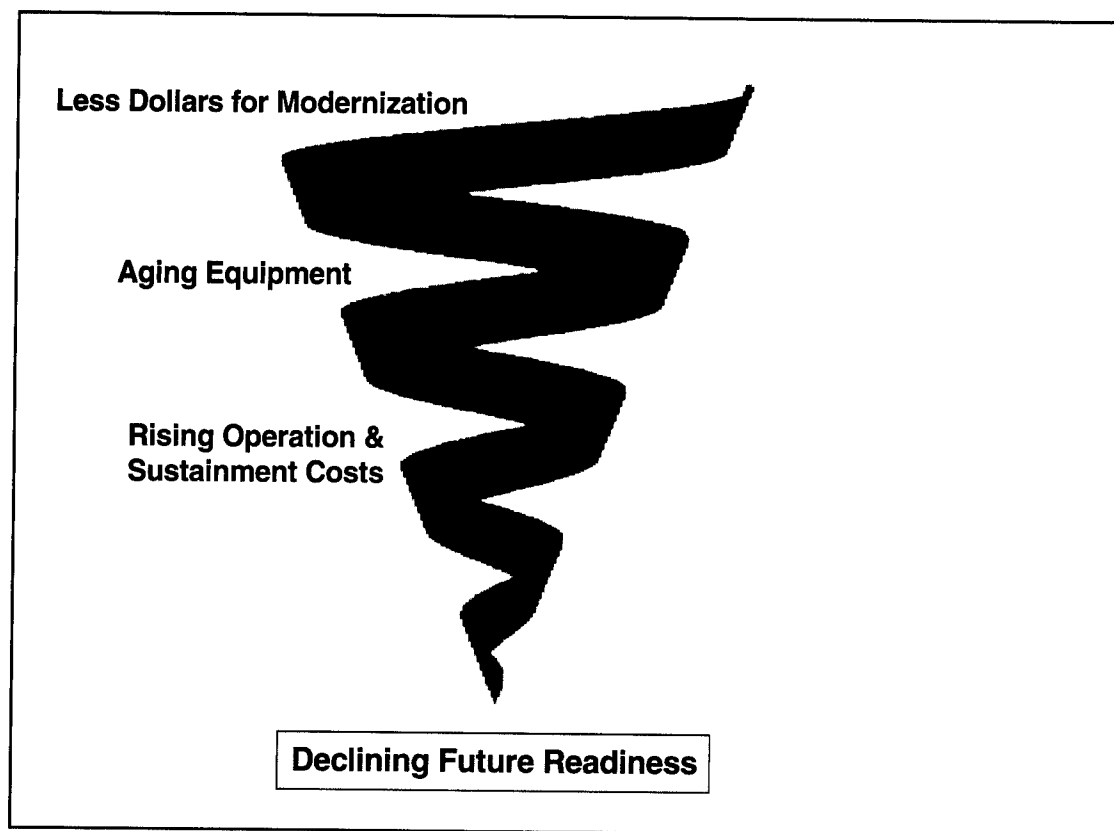


Figure 6-6. Readiness Death Spiral

of One” has replaced “Be All That You Can Be.” The question is, will this new slogan solve the Army’s recruitment problem or will it introduce future image problems?

The counterpart of the strong brand image — quality equipment — is also suffering. The effects of monetary and contingency pressures are now apparent in terms of aging equipment and increasing maintenance costs. Unfortunately this phenomenon is so prevalent throughout DoD that it has become known as the “death spiral.” Future defense readiness will continue to decline as long as modernization dollars are limited and equipment continues to age, requiring increased maintenance (see Figure 6-6).

However, the answer is not to pursue cost savings and efficiency as the primary goal. After all, these are symptoms. The Department must remedy the cause, not treat the symptoms. This analysis indicates that DoD must redirect itself to the differentiation strategy first and pursue cost *effectiveness* as a secondary goal. In other words, DoD seeks, in order of precedence: product innovation, high quality, and low cost — the best value for its customer, the warfighters. This is the strategy that has made it the world’s best military and is the strategy that, when properly executed, will allow DoD to transform to meet the challenges of the new millennium.

## DoD Corporate Strategy Execution and Outsourcing

With DoD's corporate strategy set as a differentiator, the onus is on the OSD as the corporate headquarters of DoD to ensure the strategy is effectively executed — what Cynthia Montgomery calls “being a good corporate parent.” In Chapter Two, we introduced two mechanisms that OSD could use to facilitate this endeavor. First, we will use Collis and Montgomery's Corporate Strategy Triangle as the framework for ensuring all activities within DoD are aligned with the differentiation strategy. Then we will examine the essential elements needed to establish effective levers of control. It is through these levers that DoD can positively effect change. As we go through this, we will examine how outsourcing fits into the process, addressing the findings of our research.

### Aligning DoD to the Differentiation Strategy

The Corporate Strategy Triangle framework allows OSD to build on the Department's strengths. Without such a framework one can expect the observations noted in this research. What are DoD's strengths? As we have already discussed:

- **Belief systems:** duty, honor, country, courage, commitment, integrity, service, excellence, and respect;
- **Mission and vision:** engage, shape, respond, and prepare;
- **Resources:** the best people, the best equipment, and the best training.

These are a solid foundation from which to build the DoD Corporate Strategy Triangle. However, our research pointed to three critical problems in need of correction:

1. DoD corporate strategy is not communicated effectively.
2. Linkage between the corporate strategy and performance measures is lacking.
3. Pursuit of cost-based outsourcing initiatives is misaligned from DoD corporate strategy.

Michael Beer, Russell Eisenstat, and Bert Spector state in their book, *The Critical Path to Corporate Renewal*, that a firm's competitive advantage stems from its ability to engender the necessary level of coordination, commitment, and competence. These are the essential human resource elements that drive corporate revitalization. Teamwork is essential to find and act on product improvement, quality, and cost opportunities. Therefore any revitalization effort a firm undertakes must focus on enhancing coordination.<sup>23</sup>

As we show in Chapter Four, the link from the national military strategy to DoD corporate strategy exists. Yet, 64 percent of the 232 survey respondents and 33 percent of the 111 commanders surveyed regarding DoD corporate strategy have not read it. If key personnel within DoD, who are critical to successful change, have not even read that strategy, you simply cannot achieve coordination nor instill commitment.

Furthermore, the survey responses of the approximate 130 individuals who have undertaken an outsourcing effort indicate the outsourcing initiatives currently under way may not be aligned to a common vision and there may not be a linkage between the levels of DoD (see Table 6-1).

Perhaps the reason for these results is that, in addition to A-76, DoD is exploring strategic sourcing initiatives and each of the Services is

Was the outsourcing effort aligned to:	
	Yes
DoD corporate strategy?	42.3%
Your service or agency's strategy?	66.2%
Your major command's strategy?	67.0%
Your unit's strategy?	37.6%
Your function or department's strategy?	35.9%

**Table 6-1. Outsourcing Initiative Alignment to Corporate Strategy**

experimenting with competitive or strategic sourcing efforts. According to the [OUTSOURCING JOURNAL.COM](http://OUTSOURCINGJOURNAL.COM), economies of scale are the “holy grail of outsourcing.”<sup>24</sup> Yet a corporation cannot capture the full economies of scale when each business unit is permitted to operate independently. As we said in Chapter Two, the framework also sets the boundary between strategic and tactical decision making. The commercial sector has recognized that to realize the full benefits of outsourcing, it is

a strategic investment decision, and not something to be left to subordinate units.

With this kind of fragmented approach, it is not surprising that the performance measures in use by DoD are lacking. The Department’s focus on metrics has centered on such arbitrary measures as number of positions subject to A-76 competitions or unreasonable cost savings goals. These measures focus on efficiency and don’t address the fundamental questions:

Control System	Purpose	Communicates	Control of Strategy As
<b>Beliefs Systems</b>	Empower and expand search activity	Vision	Perspective
<b>Boundary Systems</b>	Provide limits of freedom	Strategic domain	Competitive position
<b>Diagnostic Control Systems</b>	Coordinate and monitor the implementation of intended strategies	Plans and goals	Plan
<b>Interactive Control Systems</b>	Stimulate and guide emergent strategies	Strategic uncertainties	Pattern of actions
Source: R. Simons, <i>Performance Measurement &amp; Control Systems for Implementing Strategy</i> (Upper Saddle River, NJ: Prentice-Hall, 2000), p. 304.			

**Table 6-2. Relationship of Four Levers of Control to Strategy**

- Does this activity fit within DoD strategic domain?
- Does it add value to the Department?
- Are there other sources that clearly have a differentiated product or service?

The levers of control can help set the appropriate measures, but they can do far more.

### Controlling Strategy Implementation through Levers of Control

Robert Simons' *Levers of Control* are the means by which strategy is effectively executed. By way of review, the levers are belief systems, boundary systems, interactive control systems, and diagnostic control systems. The levers ensure alignment to the corporate strategy by monitoring and controlling implementation as shown in Table 6-2. These levers of control provide the additional detail on the framework from which DoD should undertake any outsourcing initiatives.

Most important, the levers are the means to fundamental transformation at the cultural level of DoD. As the subtitle of Simons' book suggests, *How Managers Use Innovative Control Systems to Drive Strategic Renewal*, they are the mechanism by which DoD leadership can strategically realign the Department to pursue a differentiation strategy. Used correctly, the levers will give DoD strategic responsiveness, adaptability, and a means to maximize the performance of a differentiation strategy.

### Belief Systems

As was stated in the previous chapter, DoD's belief system, vision, and mission are in concert with a differentiation strategy. This is not to suggest that a senior leadership review of DoD or Service belief systems wouldn't be

beneficial. Returning once again to the Johnson & Johnson Credo, Figure 2-12, it has withstood and been strengthened as a result of extensive reviews by the firm's leadership through the years.<sup>25</sup> In fact, any strategy review should include an extensive review on how that strategy is to be implemented. The driving force to DoD's ability to transform is its core ideology and belief system.

It is within the belief system that an important lesson for future outsourcing success resides. Stemming from one of DoD's strengths, people as a key resource, one must consider impact on personnel in any outsourcing effort. The survey made this point clear. As the corporate parent, OSD must establish general guidelines rather than overarching policy by which personnel issues involved in outsourcing initiatives are dealt. Unit-level managers can then use these guidelines to structure unique, win-win solutions at the local level. Mechanisms such as transition to private sector and equitable compensation and benefit packages can be successfully negotiated to ensure effectiveness. Teamwork and commitment are imperative for success.

Teamwork is a trademark of DoD. This aspect will not change. What will change is the make-up of the team. Some will get a "United States Treasury" paycheck while others will get a "Corporate America" paycheck. Yet they will all remain the *best people* working together to ensure the Department fulfills its mission. Can we make this adjustment? The team principle has been a key factor in recent successes, showing that we can.

The Department's acquisition community has undergone just such a transformation. Under acquisition reform, the relationship between the government and contractors is evolving from an adversarial one-to-one of teamwork that recognizes and leverages the benefits of partnership and collaboration. The Department must

build upon this to capture the positive benefits of partnerships in many other activities to include outsourcing initiatives. The boundary lever can help OSD determine how outsourcing initiatives support the differentiation strategy.

### Boundary Systems

The boundary system lever plays two critical roles in the transformation of DoD. First, it will enable OSD to set the boundary between strategic and tactical management. In fact, strategic management is about more than management. It's leadership that sets the domain in which the firm will operate and establishes an environment conducive to successful change. Tactical management, on the other hand, is about implementation and day-to-day management of the business. Second, the boundary system draws a clear demarcation between strategic and tactical decision rights, enabling the senior leadership of a firm to focus on questions of strategic import, such as "are we doing the right things?"

According to David Teece, strategic management is about matching a firm's capabilities to the ever-changing environment to attain its best performance.<sup>26</sup> Thus, strategic boundaries are established to manage the risk of wasting scarce resources on activities that do not support DoD's strategy — reducing investment in areas that don't affect differentiation. Conversely,

DoD may consider outsourcing areas that strengthen or reinforce value to the warfighter, focusing not on cost but on the premium it can demand for better value. Put simply, DoD should outsource activities where it no longer provides a differentiated product or service.

Historically, a comparative analysis of whether to vertically integrate into a business area or function examined the trade between the benefits and costs of bringing the function into the firm's hierarchy and the same for relying on the market (see Table 6-3).

Today's Information Economy allows a firm like Cisco to have the benefits of both structures: coordination and control, *and* strong incentives and competition. Moreover, as the firm gains competence in writing and enforcing outsourcing contracts or agreements, this cost diminishes significantly. Thus it becomes quite clear why firms worldwide are investing so much into outsourcing. The Department can learn and adapt from the commercial outsourcing successes and failures based on its years of experience in writing and enforcing contracts.

As we said in Chapter Four, strategic sourcing is a step in the right direction since the focus is on activities versus billets. The OSD needs to take the lead in designating activities DoD should source from elsewhere — set the strategic domain. To capture economies of scale

Corporate Hierarchy		Competitive Market
<b>Benefits</b>	<ul style="list-style-type: none"> <li>• Coordination</li> <li>• Control</li> </ul>	<ul style="list-style-type: none"> <li>• Strong incentives</li> <li>• Competition</li> </ul>
<b>Costs</b>	<ul style="list-style-type: none"> <li>• Weaker incentives</li> <li>• Bureaucracy</li> <li>• Inflexibility due to commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Ability to write/enforce contracts</li> </ul>

**Table 6-3. Comparative Analysis of Vertical Integration**

and scope, activities must be identified at the corporate level with input from the business units — the agencies and Services under DoD. The agencies and Services must certainly be included in the decision-making process, but they should not be making that investment decision. The agencies and Services attention should be on monitoring and controlling implementation.

Setting decision rights at the appropriate level is primarily about empowering individual leaders appropriately in order for them to manage their units effectively. The Naval Sea Systems Command Weapon Station strategic sourcing pilot program at Crane, IN, illustrates this point clearly. The Weapon Station commander was empowered to take the risk of conducting a review of all base activities. He was not hindered by a corporate “one size fits all” A-76 policy. Moreover, the commander had one simple criterion regarding these activities: do we add value?

Successful transformation of DoD will rely heavily on such empowerment and risk-tolerant pilot programs at the lower levels. As Michael Beer states, organizational revitalization requires risk-free experimentation within the firm’s strategic domain starting at the bottom of an organization and building change momentum as one learns and adapts from these experiments. As the people in the organization gain the competence, the culture within the organization begins to change and the process becomes institutionalized.<sup>27</sup> Of course, one must recognize whether the change process is on track, which means one requires sound information systems.

### **Diagnostic Control Systems**

As we stated in Chapter Two, diagnostic control systems are the formal information systems that managers use to monitor organizational

outcomes and correct deviations from preset standards of performance.<sup>28</sup> These systems have matured well beyond the traditional measures like plans, budgets, and financial systems. These measures have become knowledge fountains, spouting critical information to monitor and change behavior. Balanced Scorecard (BSC), project monitoring systems, and cost-accounting systems are examples of systems that are used diagnostically. The diagnostic control system chosen must link the strategy to intermediate goals by means of a set of critical performance measures that are balanced and not cost-centric. These are the measures that motivate personnel, help build further commitment, and foster competence.

The good news is that the Department and the Services have already experimented successfully in such initiatives as BSC. We must look to capitalize and build upon the positive aspects of that experience quickly. The bad news is that DoD’s current budget and cost accounting systems are not adequate even in a cost-centric approach nor robust enough to perform diagnostically.

As noted earlier, DoD suffers from the “Readiness Death Spiral.” This is akin to what Kaplan and Cooper term the “differentiation death spiral.”<sup>29</sup> This death spiral is fueled by a firm’s inability to estimate the incremental costs of achieving differentiation. As a firm increases product diversity, indirect and support costs escalate to handle the increased variety and complexity. Kaplan and Cooper recommend activity-based costing (ABC) be employed to give insight into the additional costs of differentiation. Armed with these cost data, a firm can make sound decisions on lowering costs.

The benefit of ABC in the public sector is illustrated by the city of Indianapolis. City budgets declined for four consecutive years, while service output increased. A single refuse crew



now serves 1,200 homes a day, up from 680.<sup>30</sup> There are numerous other opportunities for learning and adaptation within the public and private sector.

Successful re-engineering of DoD's traditional control systems into diagnostic systems will enable the Department to operate on what Kaplan called "auto pilot." Clear boundaries and effective diagnostic controls will increase DoD's Return on Management (ROM). This is essential to give the senior leadership throughout DoD the time to watch the horizon for strategic uncertainties and monitor the tension within the Department. Interactive control systems are the means for DoD to learn and adapt — to become a "learning organization."<sup>31</sup>

### Interactive Control Systems

Interactive control systems question whether you are on the right track. These systems allow you to monitor and respond to the strategic uncertainties of the business landscape. For DoD, the eroding readiness levels are its equivalent to declining market share. Advanced systems must be developed that signal the need for change, provide insight onto the details of the issue or problem, and lead directly to a corrective plan of action.

The very framework presented in this report is a step towards developing just such a control system. Similar systems exist today within the warfighting elements of DoD. As an organization, DoD should adapt John Kotter's habits that support lifelong learning:

- Risk taking: willingness to experiment;
- Humble self-reflection: honest assessment of successes and failures;
- Solicitation of opinions: aggressive collection of information and ideas;

- Careful listening: propensity to listen to others;
- Openness to new ideas: willingness to have an open mind.<sup>32</sup>

Leadership is the critical resource that will allow DoD to learn and adapt at a much quicker pace, a pace that will enable DoD to keep up with the rapidly changing environment.

### Is the New Approach Achievable?

Today's situation dictates that this approach must be achievable. Perhaps the more appropriate question is whether DoD can effect positive change. Two powerful books on change and organizational transformation, John Kotter's *Leading Change* and Michael Beer, Russell Eisenstat, and Bert Spector's *The Critical Path to Corporate Renewal*, provide insight into how DoD can succeed. Kotter's *Leading Change* is based on his analysis of dozens of change initiatives at various organizations over 15 years.<sup>33</sup> *The Critical Path to Corporate Renewal*, is based on an in-depth study of six corporations that made an effort at fundamental change.<sup>34</sup>

Three powerful lessons stem from these research efforts: the first from Kotter's work, the second emphasized in both, and the last one from Beer, et al. First, appropriate change tends to be associated with a process that creates motivation strong enough to overcome all sources of inertia.<sup>35</sup> Second, solid leadership is required to make the process work.<sup>36</sup> Third, lasting change cannot be imposed from the top, focusing narrowly on one specific area, using standardized solutions, and aiming to make sweeping change throughout the organization.<sup>37</sup> Comparing these findings to the results of this research effort yields both optimism and cause for concern.

DoD of the 20th Century	DoD in the 21st Century
Inward focus	External focus
Centralized	Empowering
Slow to make decisions	Quick to make decisions
Bureaucratic	Open and candid
Risk averse	Prudent risk takers

**Table 6-4. Change in Culture Required of DoD**

On the positive side, the urgency is there. This urgency is what makes fundamental change possible because it's the first impulse required to counter inertia. Solid leadership is abundant in the Department with its long and decorated history of developing and nurturing leadership. In addition, within the outsourcing efforts there are examples of the type of leadership needed for such, like that of the Naval Sea Systems Command Weapon Station commander at Crane. The Department must adapt this ability for developing keen military savvy into a penchant for developing sound business acumen as well.

Unfortunately, the A-76 process and strategic sourcing initiatives are not, in general, the means for making such a change. These are change mechanisms that are imposed from the top, focused on cost savings alone, done through a more standardized approach, and aimed at making this change throughout the organization. Additionally, such processes coupled with frequent changes, such as A-76 process versus strategic sourcing, tend to inoculate employees to change because of growing cynicism, a fact borne out in the survey.<sup>38</sup>

To effect positive change — change that is institutionalized into the organization — the focus must be on changing the culture in DoD. Why culture? As the research by Beer, et al

indicated, the corporation that made this kind of successful transformation instilled the key human resource activities of coordination, commitment, and competence. Yet DoD, as a traditional command-and control organization, fundamentally lacks these attributes. Such an organization requires very little coordination at the lower levels and therefore demands less commitment and competence from its employees.

The type of cultural change required in DoD is depicted in Table 6-4. As one can see, the new culture relies heavily on strategic management that understands the dynamics of the changing environment and makes quick decisions in response. It also empowers employees to make decisions appropriate to their level, and encourages prudent risk-taking and experimentation. Finally, it gives everyone in the organization the necessary information to make timely and informed decisions.

As DoD develops coordination, commitment, and competence, it should develop the lever of control systems needed to monitor the change process effectively (see Table 6-5). The levers help develop the essential human resources of coordination, commitment, and competence. The belief system develops both coordination and commitment through the vision and core ideology of teamwork. The boundary system

<b>Kotter's Leading Change Steps</b>	<b>Beer, Eisenstat, Spector Critical Path Steps</b>	<b>Simon's Levers of Control</b>
1. Establishing Urgency 2. Creating Coalition 3. Developing Vision 4. Communicating Vision	1. Mobilizing Energy 2. Developing Task-aligned Vision 3. Fostering Consensus, Competence, and Cohesion	Belief Systems
5. Empowering Employees	4. Spreading Revitalization through Process	Boundary Systems
6. Generating Short-term Wins	5. <u>Monitoring</u> (and Strategizing)	Diagnostic Control Systems
7. Consolidating Gains and Producing More Change 8. Anchoring New Approaches in Culture	6. Consolidating by Formalizing 7. (Monitoring and) <u>Strategizing</u>	Interactive Control Systems

**Table 6-5. Linking Change Processes to Levers of Control**

also fosters coordination and it helps build commitment and competence by empowering individuals to take risks and grow through experience. Competence and commitment are also developed through the diagnostic control systems by providing meaningful performance data — results. Finally, commitment is further enhanced through interactive control systems that indicate DoD is still on the right track. Coordination, commitment, and confidence are thus mutually reinforcing, building a sense of efficacy among the organization's members.<sup>39</sup> Done correctly, it's as close as one can come to a perpetual motion machine.

This is the type of organizational renewal that successful commercial firms have undergone and that the former Tactical Air Command underwent under the leadership of General Bill Creech (see Figure 6-7, Revitalizing Tactical Air Command). What is left for DoD is to build upon that body of knowledge and adapting the change process to the Department.

There are infinite obstacles to overcome and infinite opportunities to seize upon. Five Forces Analysis provides the snapshot of the obstacles to overcome and the opportunities to seize. It also lights the way to success. The Corporate Strategy Triangle framework, building on DoD's core ideology, bends the light, showing the correct way to steer toward success. The levers of control are the steering mechanism for navigating through the change process (see Figure 6-8).

### Summary

In this chapter we have demonstrated that DoD's corporate strategy must be that of a differentiator in order to meet the demands of the national security and military strategies and the environment it finds itself in today. We also provided a framework from which DoD should operate, building on the Department's strengths and identifying areas for improvement. This framework is one that works for leading commercial firms and will work for DoD.

## Revitalizing Tactical Air Command

The story of General Bill Creech, Tactical Air Command\* (TAC) commander at the time, and the revitalization of TAC is a tale of transforming a centralized, bureaucratic organization of the 20th century to a decentralized, responsive organization for the 21st century. It is all about TAC renewal through a process of change — *cultural change*.

General Creech brought about this change by focusing on the human factor of an organization to gain coordination, commitment, and competence. The critical change process principles were:

- Leadership: achieved coordination by embracing all the elements required for success — the *people*, the *equipment*, the *training*, the *planning*, the *strategy*, and the *tactics*.
- Empowerment: achieved commitment by empowering the individuals that owned the process or product, making everyone a leader in the change process.
- Teamwork: achieved competence by changing big functions to small teams that focused on quality of *team* products and outputs.

Before this transformation, TAC had a difficult time maintaining its aircraft fleet, resulting in lost training sorties despite ample budget and authorization. The following outputs resulted from successful change:

- The number of aircraft grounded for maintenance in a fleet of more than 4,000 aircraft was reduced 73 percent.
- The number of "Hangar Queens," aircraft grounded for more than three weeks, was reduced from an average of 234 a day to only eight a day.
- The rate of fixing aircraft the same day noted "broke" was improved by 270 percent.
- Finally, in Desert Shield/Desert Storm the average fighter "Mission Capable" rate was over 95 percent throughout the high-tempo operations as compared to rates of 50 percent and lower at General Creech's arrival.<sup>40</sup>

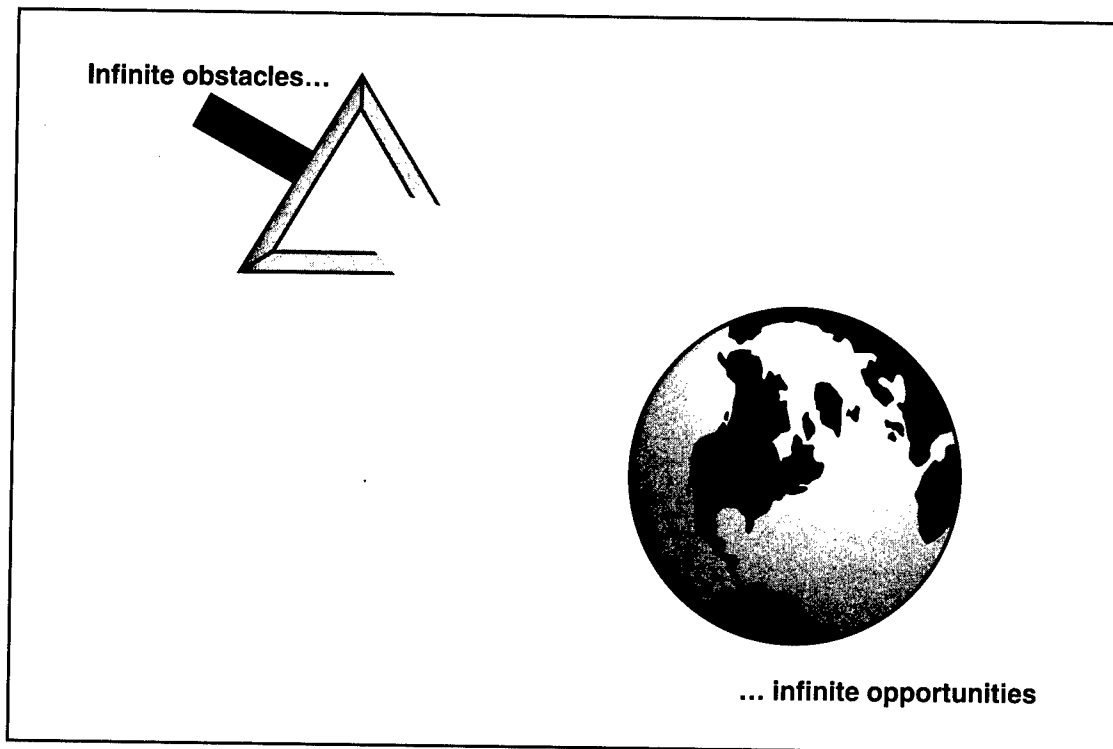
Even more remarkable than these results is the fact General Creech and the people of TAC accomplished this feat between 1978 and the mid-1980s, well before the impact of the Reagan Administration build up. The accomplishment was well recognized and lauded. In fact, the Presidential Blue Ribbon Commission on Defense Management, chaired by David Packard, cited the decentralized, quality-oriented initiative as the model for how DoD should be managed.<sup>41</sup>

(\*Tactical Air Command is now Air Combat Command)



Source: Adapted from W. Creech, *The Five Pillars of TQM: How to Make Total Quality Management Work for You*. (New York: Truman Tulley Books/Dutton, 1994), pp. 1-40, 115-157.

Figure 6-7. Revitalizing Tactical Air Command



**Figure 6-8. DoD Framework for Change**

Success in the business world begins with effective leadership that sets strategy first and then builds the corporation around that strategy. A corporation that:

- Is built on a firm foundation of a sound belief system, with an effective mission and vision statement;
- Exploits valuable resources continuously to build competitive advantage; and

- Learns and adapts responsively.

This is the framework that will again place DoD's attention onto effectiveness, determining the right thing to do versus efficiency. The framework that can and will lead to increased readiness and mission performance.

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# 7

## CONCLUSIONS AND RECOMMENDATIONS

*"A prudent question is one half of wisdom."*

— Francis Bacon

### Conclusions

Based on the information presented in this report, we will now address our hypothesis. Specifically, that on-going outsourcing initiatives will not result in the necessary performance improvements and changes required to transform the Department of Defense (DoD) to meet the challenges of the 21st century because these efforts are focused on doing things right versus doing the right thing. We do this by addressing the questions first posed in this report.

#### *Does transformation urgency exist?*

There are strong indications that transformation urgency does exist. This was borne out in the survey. Respondents clearly indicated that business as usual is unacceptable. This was a sentiment shared by all groups regardless of status (i.e., assignment, pay grade, area of functional expertise, etc.). Additionally, there is a strong degree of dissatisfaction with the mechanisms DoD is currently using to transform business processes — namely the Office of

Management and Budget (OMB) Circular A-76 (A-76) and related cost-focused initiatives.

Furthermore, this sense of urgency is sufficiently high as to make change possible and successful if change is commensurate with the tenets of DoD strategy. If, as Kotter states, a 75 percent dissatisfaction rate represents a threshold that must be reached before successful change can be enacted, DoD meets this threshold. Of 232 survey respondents, 85 percent indicated that a need exists for significant improvement in the way DoD and the departments/agencies conduct business operations.

#### *Do DoD outsourcing initiatives align with the DoD business strategy?*

Current initiatives do not align with DoD business strategy. DoD has historically followed a generic strategy of differentiation. DoD's beliefs, values, and mission are aligned to support this strategy. A-76 and related initiatives, with their focus on cost, are not well-suited for an organization such as DoD, which competes on quality, not cost.



This misalignment of strategy and outsourcing policy has generated a great deal of concern within DoD. This is especially true of base and installation commanders who must implement A-76. Installation commanders, more so than any other group surveyed, place mission performance and personnel ahead of cost. This is at odds with current outsourcing policies that place cost ahead of performance and personnel.

***Has the A-76 process generated the results expected?***

As measured by savings goals, the A-76 process has not generated the results expected. These goals are set unrealistically high and motivation to meet them is low. Additionally, any incentive to attain cost saving is secondary to impact on mission performance and personnel. These latter two are central to DoD's differentiation strategy and are strongly reflected in the Department's belief system. Furthermore, mission performance and responsibility toward subordinates are the basic tenets of diagnostic control systems at the unit level where A-76 must be executed. Cost savings, on the other hand, are the driving metric at the headquarters and staff level. This is the part of the hierarchy that creates but does not implement outsourcing strategy in its current form.

More important, A-76 has not generated the business process improvements needed to transform DoD from an old to a new model. A-76, by its nature, is a mechanism to make the old model as economical as is possible. It is not a process that is designed to foster more effective business structures.

***Has Strategic Outsourcing generated the results expected?***

Successes have been a function of the autonomy given to local leadership and to a focus

on process over economies. Local activities, working within a set of broad objectives versus a narrow methodology, are able to effect real change. Solutions are generated locally rather than being dictated from above. Instead of focusing on marginal savings, these activities have focused on process improvements as the primary consideration and bottom-line cost as a secondary concern. This improvement of business processes entails a focus on effectiveness. These more effective processes are, in turn, more efficient.

This is an inherently different approach than that of A-76. Under A-76, DoD has the same model with the same vulnerabilities both before and after these outsourcing initiatives. Further, while the model may be slightly less expensive, it is not more effective. In fact, survey data indicate that mission performance may be suffering as a result of pursuing A-76.

So long as the outsourcing strategy is cost-driven, it will be at odds with DoD's generic business strategy. One of two things can happen to rectify this conflict. Either DoD can modify outsourcing policies or it can take measures to adopt a new strategy of cost leadership. We recommend the former.

***Have shortfalls resulted from execution problems or are they strategy-related?***

Shortfalls result from incongruities in execution and business strategy as well as a reliance on actions that are at odds with DoD's belief systems. These systems emphasize mission performance and responsibility for subordinate personnel. Absent a change in these core beliefs, such considerations will always take precedence over economies.

While secondary to the incentives to perform and care for subordinates, economic incentives are still a leverage point and a force for change.

However, the current economic structure does not bring these incentives to bear. At the unit level, where these policies are executed, savings are not retained. Instead, monies saved are swept-up and retained by the Department for application elsewhere. This leaves no financial incentive to execute current policies. Instead, they must be dictated by means such as upfront budget cuts.

From the perspective of strategy, current outsourcing policy imposes a process that emphasizes cost against a strategy that emphasizes quality and performance. DoD's vision emphasizes being the best-trained, best-equipped fighting force in the world. Current Department policies indicate this vision is to be attained within the current structure but that the structure must be made more affordable. Absent fundamental changes in the organization, at some point reducing cost will erode performance. This may already be occurring.

#### ***What are the benefits of a new corporate strategy approach?***

A new approach will allow DoD to apply differentiation strategies that are in congruence with the Department's traditional beliefs, mission, and values. This will, in turn, leverage the Department's inherent strengths in order to make the fundamental changes required for more effective operations in the new strategic environment.

Such a new approach would also emphasize control mechanisms that set and maintain strong strategic boundaries. As has been pointed out, these boundaries have been lacking in the past, allowing DoD to integrate into numerous areas that lie outside its inherent strategic domain.

This new approach would also bring diagnostic controls into alignment up and down the

structure of the Department, minimizing or eliminating situations where a unit, graded on mission effectiveness, reports to a headquarters staff that is in turn graded on the efficiency of its subordinate units.

Finally, this new approach would emphasize interactive controls that would focus leadership attention on and over the strategic horizon. This would emphasize DoD business strategy as a strategy of action rather than a strategy of reaction.

#### ***Can such an approach be implemented?***

Within DoD the sense of urgency is such that change can be implemented. This is not to say change will be easy, only that the environment is ripe for action. An examination of change efforts in the business world shows that they are difficult and often painful undertakings. This is why, without this sense of urgency, they likely cannot be executed.

A sense of urgency is only the first part. After that, the change must be led by individuals who have an unflagging vision of what the right things are for the organization and the drive and determination to get there. The ability to channel this urgency is what sets apart a Jack Welch or a Lee Iacocca from an ordinary chief executive officer. These extraordinary people tapped into the sense of urgency to turn around flagging organizations and returned them to unprecedented profitability.

Fortunately, DoD has a climate that is capable of and does generate just these types of leaders. Unfortunately, in the current environment, it has also rewarded those who do not share the vision of differentiation that has traditionally guided DoD. This is another regrettable result of pursuing the conflicting strategies of differentiation and cost leadership.

While the sense of urgency does exist within the Department, we do not have data that indicate the degree to which this sense of urgency exists within Congress and among the American public. Unlike a corporation, which is answerable to a limited group of shareholders, DoD is answerable to a wide range of groups and interests, culminating with the citizens of this country. If the sense of urgency is not shared, it is likely that the support for change that is needed from outside the Department will not be sufficient to initiate and sustain transformation.

Voicing the sense of urgency that exists within DoD and the reasons for it is the challenge the Department must face. Once the public adopts this sense of urgency, transformation is possible. This is what drove the unprecedented change in times of war. It is also what has driven transformation in times of peace.

Unfortunately, what the public sees tends to dilute any sense of urgency. Internal DoD audits, press reports, and external audits such as General Accounting Office (GAO) reports focus only on waste and inefficiency. They rarely focus on a lack of effectiveness or a need for transformation. Waste and inefficiency are problems that will always need to be addressed but by the same token, they are problems that exist to varying degrees in every organization, including the top-rated companies in the world. There are more pressing questions to be addressed than whether or not things are being done right. The more powerful question is whether or not we are doing the right things in the first place.

## **Recommendations**

From this research and the conclusions that flow from it, we offer a set of recommendations. As was stated in the introduction, we are fully cognizant of the difficulties and political

realities involved in effecting major changes in large public agencies such as DoD. However, while change is difficult, change must happen. It is clear that tinkering with the old model will not create effective business processes that are in congruence with DoD's core ideology. Nor will tinkering with the old model garner the efficiencies sought by the Department. Continued reliance on cost-based strategies is a continuation down the death spiral. What is needed is a new approach. What is needed is renewal through transformation.

### ***Recommendation Number One: Suspend Cost-Based Outsourcing Initiatives***

A-76, Strategic Sourcing, and other cost-driven outsourcing will not produce the level of savings projected by DoD. Savings targets are unrealistic and unobtainable. Aggressive implementation of cost-based outsourcing is the strategic mechanism enacted to attain these savings goals. However, any strategy is worth little if it cannot be successfully executed.

More important, by emphasizing cost-based initiatives, DoD risks losing sight of its primary mission: to fight and win our nation's wars. Given this, mission cost will always be a secondary consideration not a primary focus. By vastly expanding the number of positions studied in order to achieve an unattainable savings target, the Department loses perspective and risks a great deal.

Instead of focusing on core warfighting areas that properly lie within DoD's strategic domain, the Department is instead focused on activities that do not benefit operational forces. Pursuit of cost-based outsourcing is diluting the ability of leadership to concentrate attention on mission effectiveness. This, in turn, impacts mission performance. Resources, especially leadership resources, directed to an ever-expanding number of cost studies are resources that are

not directed to the support of operational forces and the development of war-fighting skills.

Further, Department personnel see cost-based outsourcing as a budgetary manpower drill performed with little regard to mission effectiveness. An examination of these programs in practice tends to validate this position. No cost is assessed to the disruption caused by A-76 studies or to the resources that must be applied to execute them. Nor are there any diagnostic measures applied in order to gauge customer satisfaction or organizational effectiveness before, during, or after the studies. When asked to respond to the statement, "Outsourcing has improved my mission performance," 59 of the 75 installation commanders (79 percent) responded "no." Unfortunately, cost-based outsourcing relies only on efficiency measures. There are no effectiveness measures applied to the process. The sole metric is cost to perform the function.

However, complicating matters are current limitations of DoD's accounting systems and the way in which accounts are fragmented and compartmentalized. Savings at one activity or in one account do not necessarily result in savings throughout DoD. Expanding the cost analysis beyond the individual activity may in fact show an overall cost increase across the Department.

There is also an impact on organizational learning and growth. What is the consequence of cost-based outsourcing on a culture that has traditionally emphasized pride and service? For personnel performing functions that garner DoD a competitive advantage, what message is sent when they are told that quality of performance is secondary to cost? Given the vitality of the private economy, how does DoD attract and retain quality personnel in an environment where cost is apparently valued

above talent and ability? Better, faster, cheaper is often used as a mantra for streamlining initiatives. Unfortunately, under cost-based outsourcing, the mantra becomes cheaper, cheaper, cheaper.

Finally, cost-based outsourcing assumes the current business models are already effective when, in fact, they are not. A cursory view of industry shows that the private sector is leveraging technology to create business models that are far more robust and effective than those employed by DoD. Firms are using technology to develop and execute strategies that were not possible only a short time ago. Now that these strategic models have been developed and proven, DoD can adopt them to bring about a true revolution in business affairs. This begins with a properly crafted strategy built around the strengths of the Department's ideological foundations. Once such a strategy is crafted, outsourcing decisions become strategy-based, not cost-based.

#### ***Recommendation Number Two: Expand and Revalidate Survey Results***

Survey responses indicated a high degree of dissatisfaction with A-76 and other cost-based outsourcing initiatives. However, it should be noted that the sample population was quite small and it was skewed toward installation commanders, the executors of current outsourcing policies. Thirteen hundred surveys were sent out and 234 responses were received. Of these 234 responses, 111 identified themselves as being in a position of command (30 Army, 63 Air Force, and 18 Navy).

The nature of the responses indicates to us that there are significant issues with which the Department must come to grips. The first step in doing this is to conduct additional polling to validate these results. Additionally, we

recommend the Department conduct interviews in order to gauge more thoroughly the issues embodied in these responses.

When asked to elaborate, many respondents elaborated in great detail about outsourcing policies. One-on-one interviews would better capture this valuable feedback.

***Recommendation Number Three:  
Acknowledge and Communicate  
DoD Business Strategy***

Nearly two-thirds of those responding to our survey indicated they have not read the DoD Strategic Plan. More alarming still is that two-thirds of the 111 respondents in positions of command indicated they have not read the Department's Strategic Plan. We hold that it is very difficult to articulate a strategic plan if one hasn't read it in the first place. Successful organizations, especially large ones such as DoD, need well-understood cohesive strategies in order to attain effectiveness. Leaders must clearly understand the elements of the strategic plan and align their organizations in conjunction with overarching goals and objectives. This requirement is equally applicable to the business functions that compose DoD.

If DoD's Strategic Plan exists only on paper or a web site, it is of little use. It must exist in the thoughts and actions of everyone in the organization from leaders on down in order to be effective. Leaders must become owners of the overarching vision and communicate it daily. This is how strategic plans are put into effect. This is lamentable since DoD has a very well-crafted strategic plan built around the beliefs, values, and mission that inherently define the Department. Like the Johnson & Johnson Credo, it should be more than a slogan. It is a powerful plan that should be read, understood, and articulated.

***Recommendation Number Four:  
Set Strategic Boundaries and  
Establish Decision Rights***

The basic tenet behind A-76 is that the government should not compete with its citizens. Government therefore, should rely on commercial sources and only perform functions in-house that are inherently governmental in nature. If this policy dates back to 1955, how then did DoD get to the point where it finds itself with over 150,000 full-time positions that are commercial in nature and are subject to A-76 studies? The inescapable answer is that this policy has been largely ignored.

The Department must firmly establish strategic boundaries around a well defined strategic domain. This would preclude many of the costly and difficult to reverse integration decisions that have led the Department to the point where resources applied to infrastructure vastly overshadow resources directed to core mission performance.

However, even if DoD had relied on a simple check of the Yellow Pages to see if the activity was available commercially before integrating activities over the past 45 years, the Department would likely still find itself over-integrated. It does not take a great deal of rationalization to justify any activity as being inherently governmental if the qualifying characteristic is that the function is, "so intimately related to the public interest as to mandate performance by Government employees."

We hold that the concept of "inherently governmental" should be abandoned when addressing DoD business strategy. Instead, the integration decision should revolve around whether or not integrating the activity provides the Department with a competitive advantage (or conversely, whether integrating the activity will generate a strategic disadvantage). More

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to the point, if an organization can do a few things well or many things poorly, what are the few things DoD should do to be effective in the performance of its mission?

Such an approach will yield a much different answer than cost-based restructuring. It will also define a core strategic domain and a set of strategic boundaries. Once those boundaries are defined, they must in turn be enforced. This is not to say that the boundaries cannot be revisited or revised. In fact they should; but only in the context of a continued examination and analysis of competitive advantage.

Unambiguous strategic boundaries then define the areas in that leadership can operate in. It is within these bounds that leaders must be allowed to experiment and take business risks in order to generate business returns. Decision rights that allow for this experimentation should then be delegated to individual unit commanders. This moves the organization away from a rigid risk-averse hierarchy toward a responsive entity that can adapt and learn.

***Recommendation Number Five:  
Develop Balanced Diagnostic Controls***

Business elements within DoD need to establish a set of diagnostic controls that strike a balance between cost-performance and other, equally important, performance measures. Financial measures are important in any public or private sector enterprise. However, overreliance on this one measure can bring unintended consequences that adversely effect organizational performance.

Financial measures are lagging indicators. As such, they reflect short-term strategic outcomes. Unfortunately, if they become the sole focus of the firm, they can be the incentive for poor tactical choices that can degrade long-term strategy. The front page of the *Wall Street*

*Journal* typically features stories about firms that have succumbed to the temptation to generate short-term financial performance.

A loss of balance leads to a loss of perspective and adverse results that no one wanted or anticipated. Therefore, in addition to the financial perspective, we recommend that DoD include the three other measures highlighted in Kaplan and Norton's *Balanced Scorecard*:

- Customer Perspective;
- Internal-Business Perspective; and
- Learning and Growth Perspective.

Unified commanders and the operating forces in their charge are the customers of DoD business functions. Often business entities within the Department lose sight of this. As a consequence, decision making becomes focused on the resources, not on making the most of those resources in support of operating forces. Measurable and verifiable indicators of how well these customers are being served should be just as important as DoD financial measures.

Internal business measures ensure that management will focus on improving processes in order to create customer satisfaction and contribute to financial success. Cost-based outsourcing does little to motivate process improvement. The focus of cost-based outsourcing is the bottom line. A focus on internal business processes and metrics to measure improvement would go a long way to ensure DoD is pursuing effectiveness first and efficiency second.

Finally, learning and growth measures ensure that the long-term investments are made that will promote success into the future. Of course, short-term financial gains can be made by limiting long-term investment. This is one of the

dangers of current outsourcing policy. The push for marginal savings is driving talented personnel out of DoD. This may yield savings today, but it spells potential disaster in the future. For this reason, investments in personnel, education, technology, and systems, must be given equal weight with financial measures in any assessment of how well DoD is performing in fulfillment of its mission.

***Recommendation Number Six:  
Develop Interactive Controls***

This is a critical step in allowing the Department to be proactive rather than reactive. Interactive systems are necessary in order to test the strategic assumptions of the Department and make the necessary adjustments to position DoD where it can create value for its operating forces.

Had DoD a robust set of interactive controls, it might have better gauged where technology was going and how the Department should take advantage of it. This is precisely what some of the successful businesses mentioned throughout this work were able to do. This was not by accident. Successful companies look far beyond the current budget horizon in order to determine what will comprise a successful strategy and what it is that will cause the strategy to fail.

A great reminder of the need for strategy as long-term perspective is found in the local Washington, DC area. The Chesapeake and Ohio (C&O) Canal was started in 1828. It was to be a 360-mile stretch of waterway connecting the Chesapeake with Pittsburgh and the Ohio River. Twenty-two years later and at great cost, when the canal reached Cumberland, the railroad had already been there eight years. The C&O was obsolete before it was finished. In retrospect, it was folly to make such an investment, especially in light of the way rail

technology was progressing. Chesapeake and Ohio management surely could have seen their strategy was in trouble — but did they even take the trouble to look?

Are business entities within DoD building C&O canals? Are there more effective ways to achieve the Department's mission? Interactive controls facilitate learning. Without these controls, DoD will likely not know the answers to these questions until they become painfully evident.

***Recommendation Number Seven:  
Leverage Superior Technical Capabilities***

Technology is revolutionizing the business world. The power of this technological change is transforming successful firms from lumbering hierarchical structures focused on planning to lean responsive structures focused on action. Key to this is the ability to capture, process, and transmit information rapidly and accurately. Information processing is precisely the function performed by the vast majority of DoD business activities.

DoD makes and sells very little. With the exception of material provided by Defense Depots, the goods that operating forces depend upon are created in the private sector. To a large degree, what DoD infrastructure does is to provide not goods but services and to act as a medium for information to pass back and forth from industry to operational units.

If DoD creates value by facilitating this information flow, the tools of the information economy have arrived at precisely the right time to bring about the transformation the Department has been striving for. What is more, DoD does not have to wait for its personnel to become adept at applying this technology. There are firms that are already adept. Instead of integrating these activities, they may be

outsourced to such firms, leaving DoD to focus on such areas as applying rather than processing information.

***Recommendation Number Eight:  
Refocus Management Attention***

Currently within DoD, Return on Management (ROM) is low and getting worse. The amount of productive organizational energy released pales in comparison with the amount of time and attention invested. Efforts that go toward cost-based outsourcing release little productive organizational energy. Attention focused on financial measures in the absence of other balancing measures releases little productive energy. Attention focused on the preservation of resources, rather than the use of those resources to create value, releases little productive energy.

The Department, as part of an overarching strategy, needs to refocus management attention on the release of productive energy. This begins with the things we have already mentioned: the establishment of uniform strategies, strategic boundaries, realistic goals, proper incentives, clear decision rights, and the systems to put these things in effect.

Increasing ROM means creating a culture that de-emphasizes cost focus and risk aversion and instead emphasizes value creation and strikes a much needed balance between risk and return. Most important, increasing ROM means abandoning some business areas so that DoD can focus on others.

At the dawn of the 21st century, DoD finds itself over-integrated. Resources are scattered over a wide array of activities. Some of these activities provide the Department with an advantage, some do not. DoD needs to focus on the areas that yield advantage and rely on the commercial sector for activities that lie outside of that strategic domain.

This begins with developing strategies that focus on effectiveness as opposed to strategies that focus on efficiency. This means DoD must change its focus from doing things right to doing the right things.

***Recommendation Number Nine:  
Seize the Moment***

The most difficult aspect of any organizational transformation is the creation of a powerful guiding coalition. The good news is that that coalition is out there. Eighty-seven percent of the 232 who responded to the question agreed that the need exists for significant improvement in the way DoD and the departments/agencies conduct business operations. A review of their comments indicates this view is strongly held. Personnel in the department are not complacent. They want change and they understand the need for change — the commitment is there.

Of course, any real transformation is difficult but is it any less painful than the execution of current cost-based strategies? In our experience, people are willing to take the difficult path if they understand the need to take it. This understanding exists. The Department needs to abandon the easy but ineffective path of marginal cost savings and take the more difficult but more effective path of defining business structure in terms of effective strategy, not in terms of cost.

Now is the time to act and to act decisively. In this environment, where the need for change is so well understood and the opportunity for change is so great, organizational transformation is possible. The Department of Defense should seize this unique moment.





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# EPILOGUE

One of the things that impressed us at the Harvard Business School was the emphasis on ethics and the responsibilities of business leaders. Successful leaders understand that the decisions they make go beyond the bottom line. A poor decision may jeopardize not only the financial well-being of shareholders but also the financial security of company employees. More devastating still is a series of seemingly good decisions built on the precept of a poor or outdated strategy. This is what leads to the loss of competitive advantage and the demise of companies.

In the private sector, business leaders must be constantly mindful of this. The competitive landscape may change very quickly, as events of the past 15 years have demonstrated. Failure to adapt can have severe repercussions. In a competitive environment, better business models replace less effective ones. In business — as in nature — the strong survive.

Many believe the public sector is insulated from the harsh realities of competition. This is only partially true. Whereas private firms compete for revenue, market share, and advantage over their competitors, public sector entities compete for increasingly scarce resources. This type of competition prompts a focus on inputs and efficiency rather than a focus on outputs and effectiveness.

In our estimation, this results in a different competitive landscape that fosters different modes of thought and differing perceptions, including how businesses operate. In this report we have endeavored to go beyond the mere slogan that the Department of Defense (DoD) should operate more like a business. Our goal was to offer a new perspective to demonstrate what operating like a business actually means. It means much more than business efficiency. It entails a focus on the productive use of resources, processes, and culture to garner a competitive advantage. Operating like a business begins with an effective strategy.

We submit that a primary focus on effectiveness entails a critical shift in perspective that is much needed within DoD. We hope that this discussion has been worthwhile and that it has provided a framework for understanding not only some of the vexing issues the Defense Department currently faces but also better strategies for dealing with them.



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**APPENDIX A**

**CIRCULAR A-76  
EXECUTIVE OFFICE OF THE PRESIDENT  
OFFICE OF MANAGEMENT AND BUDGET  
WASHINGTON, D.C. 20503  
CIRCULAR NO. A-76 (REVISED 1999)**



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## APPENDIX A

### CIRCULAR A-76 EXECUTIVE OFFICE OF THE PRESIDENT OFFICE OF MANAGEMENT AND BUDGET WASHINGTON, D.C. 20503

#### CIRCULAR NO. A-76 (REVISED 1999)

August 4, 1983

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Performance of Commercial Activities

1. **Purpose.** This Circular establishes Federal policy regarding the performance of commercial activities and implements the statutory requirements of the Federal Activities Inventory Reform Act of 1998, Public Law 105-270. The Supplement to this Circular sets forth the procedures for determining whether commercial activities should be performed under contract with commercial sources or in-house using Government facilities and personnel.
2. **Rescission.** OMB Circular No. A-76 (Revised), dated March 29, 1979; and Transmittal Memoranda 1 through 14 and 16 through 18.
3. **Authority.** The Budget and Accounting Act of 1921 (31 U.S.C. 1 *et seq.*), The Office of Federal Procurement Policy Act Amendments of 1979. (41 U.S.C. 401 *et seq.*), and The Federal Activities Inventory Reform Act of 1998. (P. L. 105-270).
4. **Background.**
  - a. In the process of governing, the Government should not compete with its citizens. The competitive enterprise system, characterized by individual freedom and initiative, is the primary source of national economic strength. In recognition of this principle, it has been and continues to be the general policy of the Government to rely on commercial sources to supply the products and services the Government needs.
  - b. This national policy was promulgated through Bureau of the Budget Bulletins issued in 1955, 1957 and 1960. OMB Circular No. A-76 was issued in 1966. The Circular was previously revised in 1967, 1979, and 1983. The Supplement (Revised Supplemental Handbook) was previously revised in March 1996 (Transmittal Memorandum 15).

**5. Policy.** It is the policy of the United States Government to:

- a. *Achieve Economy and Enhance Productivity.* Competition enhances quality, economy, and productivity. Whenever commercial sector performance of a Government operated commercial activity is permissible, in accordance with this Circular and its Supplement, comparison of the cost of contracting and the cost of in-house performance shall be performed to determine who will do the work. When conducting cost comparisons, agencies must ensure that all costs are considered and that these costs are realistic and fair.
- b. *Retain Governmental Functions In-House.* Certain functions are inherently Governmental in nature, being so intimately related to the public interest as to mandate performance only by Federal employees. These functions are not in competition with the commercial sector. Therefore, these functions shall be performed by Government employees.
- c. *Rely on the Commercial Sector.* The Federal Government shall rely on commercially available sources to provide commercial products and services. In accordance with the provisions of this Circular and its Supplement, the Government shall not start or carry on any activity to provide a commercial product or service if the product or service can be procured more economically from a commercial source.

**6. Definitions.** For purposes of this Circular:

- a. A *commercial activity* is one which is operated by a Federal executive agency and which provides a product or service that could be obtained from a commercial source. Activities that meet the definition of an inherently Governmental function provided below are not commercial activities. A representative list of commercial activities is provided in Attachment A. A commercial activity also may be part of an organization or a type of work that is separable from other functions or activities and is suitable for performance by contract.
- b. A *conversion to contract* is the changeover of an activity from Government performance to performance under contract by a commercial source.
- c. A *conversion to in-house* is the changeover of an activity from performance under contract to Government performance.
- d. A *commercial source* is a business or other non-Federal activity located in the United States, its territories and possessions, the District of Columbia or the Commonwealth of Puerto Rico, which provides a commercial product or service.
- e. An *inherently Governmental function* is a function which is so intimately related to the public interest as to mandate performance by Government employees. Consistent with the definitions provided in the Federal Activities Inventory Reform Act of 1998 and

OFPP Policy Letter 92-1, these functions include those activities which require either the exercise of discretion in applying Government authority or the use of value judgment in making decisions for the Government. Services or products in support of inherently Governmental functions, such as those listed in Attachment A, are commercial activities and are normally subject to this Circular. Inherently Governmental functions normally fall into two categories:

- (1) *The act of governing*; i.e., the discretionary exercise of Government authority. Examples include criminal investigations, prosecutions and other judicial functions; management of Government programs requiring value judgments, as in direction of the national defense; management and direction of the Armed Services; activities performed exclusively by military personnel who are subject to deployment in a combat, combat support or combat service support role; conduct of foreign relations; selection of program priorities; direction of Federal employees; regulation of the use of space, oceans, navigable rivers and other natural resources; direction of intelligence and counter-intelligence operations; and regulation of industry and commerce, including food and drugs.
  - (2) *Monetary transactions and entitlements*, such as tax collection and revenue disbursements; control of the Treasury accounts and money supply; and the administration of public trusts.
- f. A *cost comparison* is the process of developing an estimate of the cost of Government performance of a commercial activity and comparing it, in accordance with the requirements of the Supplement, to the cost to the Government for contract performance of the activity.
- g. *Directly affected parties* are Federal employees and their representative organizations and bidders or offerors on the instant solicitation.
- h. *Interested parties* for purposes of challenging the contents of an agency's Commercial Activities Inventory under the Federal Activities Inventory Reform Act of 1998 are:
- (1) A private sector source that (A) is an actual or prospective offeror for any contract or other form of agreement to perform the activity; and (B) has a direct economic interest in performing the activity that would be adversely affected by a determination not to procure the performance of the activity from a private sector source.
  - (2) A representative of any business or professional association that includes within its membership private sector sources referred to in (1) above.
  - (3) An officer or employee of an organization within an executive agency that is an actual or prospective offeror to perform the activity.



- (4) The head of any labor organization referred to in section 7103(a) (4) of Title 5, United States Code that includes within its membership officers or employees of an organization referred to in (3) above.

**7. Scope.**

- a. Unless otherwise provided by law, this Circular and its Supplement shall apply to all executive agencies and shall provide administrative direction to heads of agencies.
- b. This Circular and its Supplement apply to printing and binding only in those agencies or departments which are exempted by law from the provisions of Title 44 of the U.S. Code.
- c. This Circular and its Supplement shall not:
  - (1) Be applicable when contrary to law, Executive Orders, or any treaty or international agreement;
  - (2) Apply to inherently Governmental functions as defined in paragraph 6.e.;
  - (3) Apply to the Department of Defense in times of a declared war or military mobilization;
  - (4) Provide authority to enter into contracts;
  - (5) Authorize contracts which establish an employer-employee relationship between the Government and contractor employees. An employer-employee relationship involves close, continual supervision of individual contractor employees by Government employees, as distinguished from general oversight of contractor operations. However, limited and necessary interaction between Government employees and contractor employees, particularly during the transition period of conversion to contract, does not establish an employer-employee relationship.
  - (6) Be used to justify conversion to contract solely to avoid personnel ceilings or salary limitations;
  - (7) Apply to the conduct of research and development. However, severable in-house commercial activities in support of research and development, such as those listed in Attachment A, are normally subject to this Circular and its Supplement; or
  - (8) Establish and shall not be construed to create any substantive or procedural basis for anyone to challenge any agency action or inaction on the basis that such action or inaction was not in accordance with this Circular, except as specifically set forth in Part 1, Chapter 3, paragraph K of the Supplement, "Appeals of Cost Comparison Decisions" and as set forth in Appendix 2, Paragraph G, consistent with Section 3 of the Federal Activities Inventory Reform Act of 1998.

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d. The requirements of the Federal Activities Inventory Reform Act of 1998 apply to the following executive agencies:

- (1) an executive department named in 5 USC 101,
- (2) a military department named in 5 USC 102, and
- (3) an independent establishment as defined in 5 USC 104.

e. The requirements of the Federal Activities Inventory Reform Act of 1998 do not apply to the following entities or activities:

- (1) the General Accounting Office,
- (2) a Government corporation or a Government controlled corporation as defined in 5 USC 103,
- (3) a non-appropriated funds instrumentality if all of its employees are referred to in 5 USC 2105(c), or
- (4) Depot-level maintenance and repair of the Department of Defense as defined in 10 USC 2460.

**8. Government Performance of a Commercial Activity.** Government performance of a commercial activity is authorized under any of the following conditions:

a. *No Satisfactory Commercial Source Available.* Either no commercial source is capable of providing the needed product or service, or use of such a source would cause unacceptable delay or disruption of an essential program. Findings shall be supported as follows:

- (1) If the finding is that no commercial source is capable of providing the needed product or service, the efforts made to find commercial sources must be documented and made available to the public upon request. These efforts shall include, in addition to consideration of preferential procurement programs (see Part I, Chapter 1, paragraph C of the Supplement) at least three notices describing the requirement in the *Commerce Business Daily* over a 90-day period or, in cases of *bona fide* urgency, two notices over a 30-day period. Specifications and requirements in the solicitation shall not be unduly restrictive and shall not exceed those required of in-house Government personnel or operations.
- (2) If the finding is that a commercial source would cause unacceptable delay or disruption of an agency program, a written explanation, approved by the assistant secretary or designee in paragraph 9.a. of the Circular, must show the specific impact on an agency mission in terms of cost and performance. Urgency alone is not adequate reason to

continue in-house operation of a commercial activity. Temporary disruption resulting from conversion to contract is not sufficient support for such a finding, nor is the possibility of a strike by contract employees. If the commercial activity has ever been performed by contract, an explanation of how the instant circumstances differ must be documented. These decisions must be made available to the public upon request.

- (3) Activities may not be justified for in-house performance solely on the basis that the activity involves or supports a classified program or the activity is required to perform an agency's basic mission.

b. *National Defense.*

- (1) The Secretary of Defense shall establish criteria for determining when Government performance of a commercial activity is required for national defense reasons. Such criteria shall be furnished to OMB, upon request.
- (2) Only the Secretary of Defense or his designee has the authority to exempt commercial activities for national defense reasons.

c. *Patient Care.* Commercial activities performed at hospitals operated by the Government shall be retained in-house if the agency head, in consultation with the agency's chief medical director, determines that in-house performance would be in the best interests of direct patient care.

d. *Lower cost.* Government performance of a commercial activity is authorized if a cost comparison prepared in accordance with the Supplement demonstrates that the Government is operating or can operate the activity on an ongoing basis at an estimated lower cost than a qualified commercial source.

**9. Action Requirements.** To ensure that the provisions of this Circular and its Supplement are followed, each agency head shall:

- a. Designate an official at the assistant secretary or equivalent level and officials at a comparable level in major component organizations to have responsibility for implementation of this Circular and its Supplement within the agency.
- b. Establish one or more offices as central points of contact to carry out implementation. These offices shall have access to all documents and data pertinent to actions taken under the Circular and its Supplement and will respond in a timely manner to all requests concerning inventories, schedules, reviews, results of cost comparisons and cost comparison data.
- c. Be guided by Federal Acquisition Regulation (FAR) Subpart 24.2 (Freedom of Information Act) in considering requests for information.

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- d. Implement this Circular and its Supplement with a minimum of internal instructions. Cost comparisons shall not be delayed pending issuance of such instructions.
  - e. Ensure the reviews of all existing in-house commercial activities are completed within a reasonable time in accordance with the Federal Activities Inventory Reform Act of 1998 and the Supplement.

**10. Annual Reporting Requirement.** As required by the Federal Activities Inventory Reform Act of 1998 and Appendix 2 of the Supplement, no later than June 30 of each year, agencies shall submit to OMB a Commercial Activities Inventory and any supplemental information requested by OMB. After review and consultation by OMB, agencies will transmit a copy of the Commercial Activities Inventory to Congress and make the contents of the Inventory available to the public. Agencies will follow the process provided in the Supplement for interested parties to challenge (and appeal) the contents of the inventory.

**11. OMB Responsibility and Contact Point.** All questions or inquiries should be submitted to the Office of Management and Budget, Room 6002 NEOB, Washington, DC 20503. Telephone number (202) 395-6104, FAX (202) 395-7230.

**12. Effective Date.** This Circular and the changes to its Supplement are effective immediately.

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**Attachment A**

**OMB Circular No. A-76**

**EXAMPLES OF COMMERCIAL ACTIVITIES**

**Audiovisual Products and Services**

- Photography (still, movie, aerial, etc.)
- Photographic processing (developing, printing, enlarging, etc.)
- Film and videotape production (script writing, direction, animation, editing, acting, etc.)
- Microfilming and other microforms
- Art and graphics services
- Distribution of audiovisual materials
- Reproduction and duplication of audiovisual products
- Audiovisual facility management and operation
- Maintenance of audiovisual equipment

**Automatic Data Processing**

- ADP services – batch processing, time-sharing, facility management, etc.
- Programming and systems analysis, design, development, and simulation
- Key punching, data entry, transmission, and teleprocessing services
- Systems engineering and installation
- Equipment installation, operation, and maintenance

**Food Services**

- Operation of cafeterias, mess halls, kitchens, bakeries, dairies, and commissaries
- Vending machines
- Ice and water

**Health Services**

- Surgical, medical, dental, and psychiatric care
- Hospitalization, outpatient, and nursing care
- Physical examinations
- Eye and hearing examinations and manufacturing and fitting glasses and hearing aids
- Medical and dental laboratories
- Dispensaries
- Preventive medicine
- Dietary services
- Veterinary services

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**Industrial Shops and Services**

- Machine, carpentry, electrical, plumbing, painting, and other shops
- Industrial gas production and recharging
- Equipment and instrument fabrication, repair and calibration
- Plumbing, heating, electrical, and air conditioning services, including repair
- Fire protection and prevention services
- Custodial and janitorial services
- Refuse collection and processing

**Maintenance, Overhaul, Repair, and Testing**

- Aircraft and aircraft components
- Ships, boats, and components
- Motor vehicles
- Combat vehicles
- Railway systems
- Electronic equipment and systems
- Weapons and weapon systems
- Medical and dental equipment
- Office furniture and equipment
- Industrial plant equipment
- Photographic equipment
- Space systems

**Management Support Services**

- Advertising and public relations services
- Financial and payroll services
- Debt collection

**Manufacturing, Fabrication, Processing, Testing, and Packaging**

- Ordnance equipment
- Clothing and fabric products
- Liquid, gaseous, and chemical products
- Lumber products
- Communications and electronics equipment
- Rubber and plastic products
- Optical and related products
- Sheet metal and foundry products

Machined products  
Construction materials  
Test and instrumentation equipment

#### **Office and Administrative Services**

Library operations  
Stenographic recording and transcribing  
Word processing/data entry/typing services  
Mail/messenger  
Translation  
Management information systems, products and distribution  
Financial auditing and services  
Compliance auditing  
Court reporting  
Material management  
Supply services

#### **Other Services**

Laundry and dry cleaning  
Mapping and charting  
Architect and engineer services  
Geological surveys  
Cataloging  
Training – academic, technical, vocational, and specialized operation of utility systems  
(power, gas, water steam, and sewage)  
Laboratory testing services

#### **Printing and Reproduction**

Facility management and operation  
Printing and binding – where the agency or department is exempted from the provisions of  
Title 44 of the U.S. Code  
Reproduction, copying, and duplication  
Blueprinting

#### **Real Property**

Design, engineering, construction, modification, repair, and maintenance of buildings and  
structures; building mechanical and electrical equipment and systems; elevators;  
escalators; moving walks



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Construction, alteration, repair, and maintenance of roads and other surfaced areas  
Landscaping, drainage, mowing and care of grounds  
Dredging of waterways

**Security**

Guard and protective services  
Systems engineering, installation, and maintenance of security systems and individual privacy systems  
Forensic laboratories

**Special Studies and Analyses**

Cost benefit analyses  
Statistical analyses  
Scientific data studies  
Regulatory studies  
Defense, education, energy studies  
Legal/litigation studies  
Management studies

**Systems Engineering, Installation, Operation, Maintenance, and Testing**

Communications systems – voice, message, data, radio, wire, microwave, and satellite  
Missile ranges  
Satellite tracking and data acquisition  
Radar detection and tracking  
Television systems – studio and transmission equipment, distribution systems, receivers, antennas, etc.  
Recreational areas  
Bulk storage facilities

**Transportation**

Operation of motor pools  
Bus service  
Vehicle operation and maintenance  
Air, water, and land transportation of people and things  
Trucking and hauling

**APPENDIX B**

**FEDERAL ACTIVITIES INVENTORY**  
**REFORM ACT OF 1998**  
**105TH CONGRESS**



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## **APPENDIX B**

### **FEDERAL ACTIVITIES INVENTORY REFORM ACT OF 1998 105TH CONGRESS**

An Act To provide a process for identifying the functions of the Federal Government that are not inherently governmental functions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

#### **SECTION 1. SHORT TITLE.**

This Act may be cited as the “Federal Activities Inventory Reform Act of 1998”.

#### **SEC. 2. ANNUAL LISTS OF GOVERNMENT ACTIVITIES NOT INHERENTLY GOVERNMENTAL IN NATURE.**

- (a) Lists Required.—Not later than the end of the third quarter of each fiscal year, the head of each executive agency shall submit to the Director of the Office of Management and Budget a list of activities performed by Federal Government sources for the executive agency that, in the judgment of the head of the executive agency, are not inherently governmental functions. The entry for an activity on the list shall include the following:
  - (1) The fiscal year for which the activity first appeared on a list prepared under this section.
  - (2) The number of full-time employees (or its equivalent) that are necessary for the performance of the activity by a Federal Government source.
  - (3) The name of a Federal Government employee responsible for the activity from whom additional information about the activity may be obtained.
- (a) OMB Review and Consultation.—The Director of the Office of Management and Budget shall review the executive agency’s list for a fiscal year and consult with the head of the executive agency regarding the content of the final list for that fiscal year.
- (b) Public Availability of Lists.—
  - (1) Publication.—Upon the completion of the review and consultation regarding a list of an executive agency—
    - (A) the head of the executive agency shall promptly transmit a copy of the list to Congress and make the list available to the public; and
    - (B) the Director of the Office of Management and Budget shall promptly publish in the Federal Register a notice that the list is available to the public.

- (2) Changes.—If the list changes after the publication of the notice as a result of the resolution of a challenge under section 3, the head of the executive agency shall promptly—
- (A) make each such change available to the public and transmit a copy of the change to Congress; and publish in the Federal Register a notice that the change is available to the public.
- (a) Competition Required.—Within a reasonable time after the date on which a notice of the public availability of a list is published under subsection (c), the head of the executive agency concerned shall review the activities on the list. Each time that the head of the executive agency considers contracting with a private sector source for the performance of such an activity, the head of the executive agency shall use a competitive process to select the source (except as may otherwise be provided in a law other than this Act, an Executive order, regulations, or any executive branch circular setting forth requirements or guidance that is issued by competent executive authority). The Director of the Office of Management and Budget shall issue guidance for the administration of this subsection.
- (b) Realistic and Fair Cost Comparisons.—For the purpose of determining whether to contract with a source in the private sector for the performance of an executive agency activity on the list on the basis of a comparison of the costs of procuring services from such a source with the costs of performing that activity by the executive agency, the head of the executive agency shall ensure that all costs (including the costs of quality assurance, technical monitoring of the performance of such function, liability insurance, employee retirement and disability benefits, and all other overhead costs) are considered and that the costs considered are realistic and fair.

### **SEC. 3. CHALLENGES TO THE LIST.**

- (a) Challenge Authorized.—An interested party may submit to an executive agency a challenge of an omission of a particular activity from, or an inclusion of a particular activity on, a list for which a notice of public availability has been published under section 2.
- (b) Interested Party Defined.—For the purposes of this section, the term “interested party”, with respect to an activity referred to in subsection (a), means the following:
- (1) A private sector source that—
- (A) is an actual or prospective offeror for any contract, or other form of agreement, to perform the activity; and
- (B) has a direct economic interest in performing the activity that would be adversely affected by a determination not to procure the performance of the activity from a private sector source.
- (2) A representative of any business or professional association that includes within its membership private sector sources referred to in paragraph (1).
- (3) An officer or employee of an organization within an executive agency that is an actual or prospective offeror to perform the activity.
- (4) The head of any labor organization referred to in section 7103(a)(4) of title 5, United States Code, that includes within its membership officers or employees of an organization referred to in paragraph (3).

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- (c) Time for Submission.—A challenge to a list shall be submitted to the executive agency concerned within 30 days after the publication of the notice of the public availability of the list under section 2.
  - (d) Initial Decision.—Within 28 days after an executive agency receives a challenge, an official designated by the head of the executive agency shall—
    - (1) decide the challenge; and
    - (2) transmit to the party submitting the challenge a written notification of the decision together with a discussion of the rationale for the decision and an explanation of the party's right to appeal under subsection (e).
  - (e) Appeal.—
    - (1) Authorization of appeal.—An interested party may appeal an adverse decision of the official to the head of the executive agency within 10 days after receiving a notification of the decision under subsection (d).
    - (2) Decision on appeal.—Within 10 days after the head of an executive agency receives an appeal of a decision under paragraph (1), the head of the executive agency shall decide the appeal and transmit to the party submitting the appeal a written notification of the decision together with a discussion of the rationale for the decision.

#### **SEC. 4. APPLICABILITY.**

- (a) Executive Agencies Covered.—Except as provided in subsection (b), this Act applies to the following executive agencies:
  - (1) Executive department.—An executive department named in section 101 of title 5, United States Code.
  - (2) Military department.—A military department named in section 102 of title 5, United States Code.
  - (3) Independent establishment.—An independent establishment, as defined in section 104 of title 5, United States Code.
- (b) Exceptions.—This Act does not apply to or with respect to the following:
  - (1) General accounting office.—The General Accounting Office.
  - (2) Government corporation.—A Government corporation or a Government controlled corporation, as those terms are defined in section 103 of title 5, United States Code.
  - (3) Nonappropriated funds instrumentality.—A part of a department or agency if all of the employees of that part of the department or agency are employees referred to in section 2105(c) of title 5, United States Code.
  - (4) Certain depot-level maintenance and repair.—Depot-level maintenance and repair of the Department of Defense (as defined in section 2460 of title 10, United States Code).

#### **SEC. 5. DEFINITIONS.**

In this Act:

- (1) Federal government source.—The term “Federal Government source”, with respect to performance of an activity, means any organization within an executive agency that uses Federal Government employees to perform the activity.

(2) Inherently governmental function.—

(A) Definition.—The term “inherently governmental function” means a function that is so intimately related to the public interest as to require performance by Federal Government employees.

(B) Functions included.—The term includes activities that require either the exercise of discretion in applying Federal Government authority or the making of value judgments in making decisions for the Federal Government, including judgments relating to monetary transactions and entitlements. An inherently governmental function involves, among other things, the interpretation and execution of the laws of the United States so as—

- (i) to bind the United States to take or not to take some action by contract, policy, regulation, authorization, order, or otherwise;
- (ii) to determine, protect, and advance United States economic, political, territorial, property, or other interests by military or diplomatic action, civil or criminal judicial proceedings, contract management, or otherwise;
- (iii) to significantly affect the life, liberty, or property of private persons;
- (iv) to commission, appoint, direct, or control officers or employees of the United States; or
- (v) to exert ultimate control over the acquisition, use, or disposition of the property, real or personal, tangible or intangible, of the United States, including the collection, control, or disbursement of appropriated and other Federal funds.

(A) Functions excluded.—The term does not normally include—

- (i) gathering information for or providing advice, opinions, recommendations, or ideas to Federal Government officials; or
- (ii) any function that is primarily ministerial and internal in nature (such as building security, mail operations, operation of cafeterias, housekeeping, facilities operations and maintenance, warehouse operations, motor vehicle fleet management operations, or other routine electrical or mechanical services).

## **SEC. 6. EFFECTIVE DATE.**

This Act shall take effect on October 1, 1998.

Approved October 19, 1998.

## **Government Performance and Results Act of 1993**

One Hundred Third Congress of the United States of America

### **AT THE FIRST SESSION**

Begun and held at the City of Washington on Tuesday, the fifth day of January, one thousand nine hundred and ninety-three

An Act To provide for the establishment of strategic planning and performance measurement in the Federal Government, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

### **SECTION 1. SHORT TITLE**

This Act may be cited as the Government Performance and Results Act of 1993.

### **SEC. 2. FINDINGS AND PURPOSES.**

#### **(a) FINDINGS- The Congress finds that—**

1. waste and inefficiency in Federal programs undermine the confidence of the American people in the Government and reduces the Federal Government's ability to address adequately vital public needs;
2. Federal managers are seriously disadvantaged in their efforts to improve program efficiency and effectiveness, because of insufficient articulation of program goals and inadequate information on program performance; and
3. congressional policymaking, spending decisions and program oversight are seriously handicapped by insufficient attention to program performance and results.

#### **(b) PURPOSES- The purposes of this Act are to—**

1. improve the confidence of the American people in the capability of the Federal Government, by systematically holding Federal agencies accountable for achieving program results;
2. initiate program performance reform with a series of pilot projects in setting program goals, measuring program performance against those goals, and reporting publicly on their progress;
3. improve Federal program effectiveness and public accountability by promoting a new focus on results, service quality, and customer satisfaction;
4. help Federal managers improve service delivery, by requiring that they plan for meeting program objectives and by providing them with information about program results and service quality;



5. improve congressional decisionmaking by providing more objective information on achieving statutory objectives, and on the relative effectiveness and efficiency of Federal programs and spending; and
6. improve internal management of the Federal Government.

### **SEC. 3. STRATEGIC PLANNING.**

Chapter 3 of title 5, United States Code, is amended by adding after section 305 the following new section: Sec. 306. Strategic plans

- a. No later than September 30, 1997, the head of each agency shall submit to the Director of the Office of Management and Budget and to the Congress a strategic plan for program activities. Such plan shall contain—
  1. a comprehensive mission statement covering the major functions and operations of the agency;
  2. general goals and objectives, including outcome-related goals and objectives, for the major functions and operations of the agency;
  3. a description of how the goals and objectives are to be achieved, including a description of the operational processes, skills and technology, and the human, capital, information, and other resources required to meet those goals and objectives;
  4. a description of how the performance goals included in the plan required by section 1115(a) of title 31 shall be related to the general goals and objectives in the strategic plan;
  5. an identification of those key factors external to the agency and beyond its control that could significantly affect the achievement of the general goals and objectives; and
  6. a description of the program evaluations used in establishing or revising general goals and objectives, with a schedule for future program evaluations.
- b. The strategic plan shall cover a period of not less than five years forward from the fiscal year in which it is submitted, and shall be updated and revised at least every three years.
- c. The performance plan required by section 1115 of title 31 shall be consistent with the agency's strategic plan. A performance plan may not be submitted for a fiscal year not covered by a current strategic plan under this section.
- d. When developing a strategic plan, the agency shall consult with the Congress, and shall solicit and consider the views and suggestions of those entities potentially affected by or interested in such a plan.
- e. The functions and activities of this section shall be considered to be inherently Governmental functions. The drafting of strategic plans under this section shall be performed only by Federal employees.
- f. For purposes of this section the term agency means an Executive agency defined under section 105, but does not include the Central Intelligence Agency, the General Accounting Office, the Panama Canal Commission, the United States Postal Service, and the Postal Rate Commission.

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## **SEC. 4. ANNUAL PERFORMANCE PLANS AND REPORTS.**

### **(a) BUDGET CONTENTS AND SUBMISSION TO CONGRESS**

Section 1105(a) of title 31, United States Code, is amended by adding at the end thereof the following new paragraph: (29) beginning with fiscal year 1999, a Federal Government performance plan for the overall budget as provided for under section 1115.

### **(b) PERFORMANCE PLANS AND REPORTS**

- Chapter 11 of title 31, United States Code, is amended by adding after section 1114 the following new sections:

#### **Sec. 1115. Performance plans**

- a. In carrying out the provisions of section 1105(a)(29), the Director of the Office of Management and Budget shall require each agency to prepare an annual performance plan covering each program activity set forth in the budget of such agency. Such plan shall—
  1. establish performance goals to define the level of performance to be achieved by a program activity;
  2. express such goals in an objective, quantifiable, and measurable form unless authorized to be in an alternative form under subsection (b);
  3. briefly describe the operational processes, skills and technology, and the human, capital, information, or other resources required to meet the performance goals;
  4. establish performance indicators to be used in measuring or assessing the relevant outputs, service levels, and outcomes of each program activity;
  5. provide a basis for comparing actual program results with the established performance goals; and
  6. describe the means to be used to verify and validate measured values.
- b. If an agency, in consultation with the Director of the Office of Management and Budget, determines that it is not feasible to express the performance goals for a particular program activity in an objective, quantifiable, and measurable form, the Director of the Office of Management and Budget may authorize an alternative form. Such alternative form shall—
  1. include separate descriptive statements of—
    - (A) (i) a minimally effective program, and
    - (ii) a successful program, or
    - (B) such alternative as authorized by the Director of the Office of Management and Budget, with sufficient precision and in such terms that would allow for an accurate, independent determination of whether the program activity's performance meets the criteria of the description; or
  2. state why it is infeasible or impractical to express a performance goal in any form for the program activity.

- c. For the purpose of complying with this section, an agency may aggregate, disaggregate, or consolidate program activities, except that any aggregation or consolidation may not omit or minimize the significance of any program activity constituting a major function or operation for the agency.
- d. An agency may submit with its annual performance plan an appendix covering any portion of the plan that—
  - 1. is specifically authorized under criteria established by an Executive order to be kept secret in the interest of national defense or foreign policy; and
  - 2. is properly classified pursuant to such Executive order.
- e. The functions and activities of this section shall be considered to be inherently Governmental functions. The drafting of performance plans under this section shall be performed only by Federal employees.
- f. For purposes of this section and sections 1116 through 1119, and sections 9703 and 9704 the term—
  - 1. agency has the same meaning as such term is defined under section 306(f) of title 5;
  - 2. outcome measure means an assessment of the results of a program activity compared to its intended purpose;
  - 3. output measure means the tabulation, calculation, or recording of activity or effort and can be expressed in a quantitative or qualitative manner;
  - 4. performance goal means a target level of performance expressed as a tangible, measurable objective, against which actual achievement can be compared, including a goal expressed as a quantitative standard, value, or rate;
  - 5. performance indicator means a particular value or characteristic used to measure output or outcome;
  - 6. program activity means a specific activity or project as listed in the program and financing schedules of the annual budget of the United States Government; and
  - 7. program evaluation means an assessment, through objective measurement and systematic analysis, of the manner and extent to which Federal programs achieve intended objectives.

#### **Sec. 1116. Program performance reports**

- a. No later than March 31, 2000, and no later than March 31 of each year thereafter, the head of each agency shall prepare and submit to the President and the Congress, a report on program performance for the previous fiscal year.
- b.
  - 1. Each program performance report shall set forth the performance indicators established in the agency performance plan under section 1115, along with the actual program performance achieved compared with the performance goals expressed in the plan for that fiscal year.
  - 2. If performance goals are specified in an alternative form under section 1115(b), the results of such program shall be described in relation to such specifications, including whether the performance failed to meet the criteria of a minimally effective or successful program.

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- c. The report for fiscal year 2000 shall include actual results for the preceding fiscal year, the report for fiscal year 2001 shall include actual results for the two preceding fiscal years, and the report for fiscal year 2002 and all subsequent reports shall include actual results for the three preceding fiscal years.
  - d. Each report shall—
    - 1. review the success of achieving the performance goals of the fiscal year;
    - 2. evaluate the performance plan for the current fiscal year relative to the performance achieved toward the performance goals in the fiscal year covered by the report;
    - 3. explain and describe, where a performance goal has not been met (including when a program activity's performance is determined not to have met the criteria of a successful program activity under section 1115(b)(1)(A)(ii) or a corresponding level of achievement if another alternative form is used)—
      - A. why the goal was not met;
      - B. those plans and schedules for achieving the established performance goal; and
      - C. if the performance goal is impractical or infeasible, why that is the case and what action is recommended;
    - 4. describe the use and assess the effectiveness in achieving performance goals of any waiver under section 9703 of this title; and
    - 5. include the summary findings of those program evaluations completed during the fiscal year covered by the report.
  - e. An agency head may include all program performance information required annually under this section in an annual financial statement required under section 3515 if any such statement is submitted to the Congress no later than March 31 of the applicable fiscal year.
  - f. The functions and activities of this section shall be considered to be inherently Governmental functions. The drafting of program performance reports under this section shall be performed only by Federal employees.

#### **Sec. 1117. Exemption**

The Director of the Office of Management and Budget may exempt from the requirements of sections 1115 and 1116 of this title and section 306 of title 5, any agency with annual outlays of \$20,000,000 or less.

### **SEC. 5. MANAGERIAL ACCOUNTABILITY AND FLEXIBILITY.**

#### **(a) MANAGERIAL ACCOUNTABILITY AND FLEXIBILITY**

- Chapter 97 of title 31, United States Code, is amended by adding after section 9702, the following new section: Sec. 9703. Managerial accountability and flexibility

- a. Beginning with fiscal year 1999, the performance plans required under section 1115 may include proposals to waive administrative procedural requirements and controls, including specification of personnel staffing levels, limitations on compensation or remuneration, and prohibitions or restrictions on funding transfers among budget

object classification 20 and subclassifications 11, 12, 31, and 32 of each annual budget submitted under section 1105, in return for specific individual or organization accountability to achieve a performance goal. In preparing and submitting the performance plan under section 1105(a)(29), the Director of the Office of Management and Budget shall review and may approve any proposed waivers. A waiver shall take effect at the beginning of the fiscal year for which the waiver is approved.

- b. Any such proposal under subsection (a) shall describe the anticipated effects on performance resulting from greater managerial or organizational flexibility, discretion, and authority, and shall quantify the expected improvements in performance resulting from any waiver. The expected improvements shall be compared to current actual performance, and to the projected level of performance that would be achieved independent of any waiver.
- c. Any proposal waiving limitations on compensation or remuneration shall precisely express the monetary change in compensation or remuneration amounts, such as bonuses or awards, that shall result from meeting, exceeding, or failing to meet performance goals.
- d. Any proposed waiver of procedural requirements or controls imposed by an agency (other than the proposing agency or the Office of Management and Budget) may not be included in a performance plan unless it is endorsed by the agency that established the requirement, and the endorsement included in the proposing agency's performance plan.
- e. A waiver shall be in effect for one or two years as specified by the Director of the Office of Management and Budget in approving the waiver. A waiver may be renewed for a subsequent year. After a waiver has been in effect for three consecutive years, the performance plan prepared under section 1115 may propose that a waiver, other than a waiver of limitations on compensation or remuneration, be made permanent.
- f. For purposes of this section, the definitions under section 1115(f) shall apply.

## **SEC. 6. PILOT PROJECTS.**

### **(a) PERFORMANCE PLANS AND REPORTS-**

Chapter 11 of title 31, United States Code, is amended by inserting after section 1117 (as added by section 4 of this Act) the following new section: Sec. 1118. Pilot projects for performance goals

1. The Director of the Office of Management and Budget, after consultation with the head of each agency, shall designate not less than ten agencies as pilot projects in performance measurement for fiscal years 1994, 1995, and 1996. The selected agencies shall reflect a representative range of Government functions and capabilities in measuring and reporting program performance.
2. Pilot projects in the designated agencies shall undertake the preparation of performance plans under section 1115, and program performance reports under section 1116, other than section 1116(c), for one or more of the major functions and operations of the agency.

A strategic plan shall be used when preparing agency performance plans during one or more years of the pilot period.

3. No later than May 1, 1997, the Director of the Office of Management and Budget shall submit a report to the President and to the Congress which shall—
  1. assess the benefits, costs, and usefulness of the plans and reports prepared by the pilot agencies in meeting the purposes of the Government Performance and Results Act of 1993;
  2. identify any significant difficulties experienced by the pilot agencies in preparing plans and reports; and
  3. set forth any recommended changes in the requirements of the provisions of Government Performance and Results Act of 1993, section 306 of title 5, sections 1105, 1115, 1116, 1117, 1119 and 9703 of this title, and this section.

#### **(b) MANAGERIAL ACCOUNTABILITY AND FLEXIBILITY**

- Chapter 97 of title 31, United States Code, is amended by inserting after section 9703 (as added by section 5 of this Act) the following new section: Sec. 9704. Pilot projects for managerial accountability and flexibility

1. The Director of the Office of Management and Budget shall designate not less than five agencies as pilot projects in managerial accountability and flexibility for fiscal years 1995 and 1996. Such agencies shall be selected from those designated as pilot projects under section 1118 and shall reflect a representative range of Government functions and capabilities in measuring and reporting program performance.
2. Pilot projects in the designated agencies shall include proposed waivers in accordance with section 9703 for one or more of the major functions and operations of the agency.
3. The Director of the Office of Management and Budget shall include in the report to the President and to the Congress required under section 1118(c)—
  1. an assessment of the benefits, costs, and usefulness of increasing managerial and organizational flexibility, discretion, and authority in exchange for improved performance through a waiver; and
  2. an identification of any significant difficulties experienced by the pilot agencies in preparing proposed waivers.
4. For purposes of this section the definitions under section 1115(f) shall apply.

#### **(c) PERFORMANCE BUDGETING**

- Chapter 11 of title 31, United States Code, is amended by inserting after section 1118 (as added by section 6 of this Act) the following new section: Sec. 1119. Pilot projects for performance budgeting

- a. The Director of the Office of Management and Budget, after consultation with the head of each agency shall designate not less than five agencies as pilot projects in performance budgeting for fiscal years 1998 and 1999. At least three of the agencies

shall be selected from those designated as pilot projects under section 1118, and shall also reflect a representative range of Government functions and capabilities in measuring and reporting program performance.

- b. Pilot projects in the designated agencies shall cover the preparation of performance budgets. Such budgets shall present, for one or more of the major functions and operations of the agency, the varying levels of performance, including outcome-related performance, that would result from different budgeted amounts.
- c. The Director of the Office of Management and Budget shall include, as an alternative budget presentation in the budget submitted under section 1105 for fiscal year 1999, the performance budgets of the designated agencies for this fiscal year.
- d. No later than March 31, 2001, the Director of the Office of Management and Budget shall transmit a report to the President and to the Congress on the performance budgeting pilot projects which shall—
  - 1. assess the feasibility and advisability of including a performance budget as part of the annual budget submitted under section 1105;
  - 2. describe any difficulties encountered by the pilot agencies in preparing a performance budget;
  - 3. recommend whether legislation requiring performance budgets should be proposed and the general provisions of any legislation; and
  - 4. set forth any recommended changes in the other requirements of the Government Performance and Results Act of 1993, section 306 of title 5, sections 1105, 1115, 1116, 1117, and 9703 of this title, and this section.
- e. After receipt of the report required under subsection (d), the Congress may specify that a performance budget be submitted as part of the annual budget submitted under section 1105.

## **SEC. 7. UNITED STATES POSTAL SERVICE.**

Part III of title 39, United States Code, is amended by adding at the end thereof the following new chapter:

### **CHAPTER 28—STRATEGIC PLANNING AND PERFORMANCE MANAGEMENT**

Sec.

2801. Definitions.

2802. Strategic plans.

2803. Performance plans.

2804. Program performance reports.

2805. Inherently Governmental functions.

#### **Sec. 2801. Definitions**

For purposes of this chapter the term—

- 1. outcome measure refers to an assessment of the results of a program activity compared to its intended purpose;

2. output measure refers to the tabulation, calculation, or recording of activity or effort and can be expressed in a quantitative or qualitative manner;
3. performance goal means a target level of performance expressed as a tangible, measurable objective, against which actual achievement shall be compared, including a goal expressed as a quantitative standard, value, or rate;
4. performance indicator refers to a particular value or characteristic used to measure output or outcome;
5. program activity means a specific activity related to the mission of the Postal Service; and
6. program evaluation means an assessment, through objective measurement and systematic analysis, of the manner and extent to which Postal Service programs achieve intended objectives.

#### **Sec. 2802. Strategic plans**

- a. No later than September 30, 1997, the Postal Service shall submit to the President and the Congress a strategic plan for its program activities. Such plan shall contain—
  1. a comprehensive mission statement covering the major functions and operations of the Postal Service;
  2. general goals and objectives, including outcome-related goals and objectives, for the major functions and operations of the Postal Service;
  3. a description of how the goals and objectives are to be achieved, including a description of the operational processes, skills and technology, and the human, capital, information, and other resources required to meet those goals and objectives;
  4. a description of how the performance goals included in the plan required under section 2803 shall be related to the general goals and objectives in the strategic plan;
  5. an identification of those key factors external to the Postal Service and beyond its control that could significantly affect the achievement of the general goals and objectives; and
  6. a description of the program evaluations used in establishing or revising general goals and objectives, with a schedule for future program evaluations.
- b. The strategic plan shall cover a period of not less than five years forward from the fiscal year in which it is submitted, and shall be updated and revised at least every three years.
- c. The performance plan required under section 2803 shall be consistent with the Postal Services strategic plan. A performance plan may not be submitted for a fiscal year not covered by a current strategic plan under this section.
- d. When developing a strategic plan, the Postal Service shall solicit and consider the views and suggestions of those entities potentially affected by or interested in such a plan, and shall advise the Congress of the contents of the plan.

#### **Sec. 2803. Performance plans**

- a. The Postal Service shall prepare an annual performance plan covering each program activity set forth in the Postal Service budget, which shall be included in the comprehensive statement presented under section 2401(g) of this title. Such plan shall—



1. establish performance goals to define the level of performance to be achieved by a program activity;
  2. express such goals in an objective, quantifiable, and measurable form unless an alternative form is used under subsection (b);
  3. briefly describe the operational processes, skills and technology, and the human, capital, information, or other resources required to meet the performance goals;
  4. establish performance indicators to be used in measuring or assessing the relevant outputs, service levels, and outcomes of each program activity;
  5. provide a basis for comparing actual program results with the established performance goals; and
  6. describe the means to be used to verify and validate measured values.
- b. If the Postal Service determines that it is not feasible to express the performance goals for a particular program activity in an objective, quantifiable, and measurable form, the Postal Service may use an alternative form. Such alternative form shall—
1. include separate descriptive statements of—
    - A. a minimally effective program, and
    - B. a successful program, with sufficient precision and in such terms that would allow for an accurate, independent determination of whether the program activity performance meets the criteria of either description; or
  2. state why it is infeasible or impractical to express a performance goal in any form for the program activity.
- c. In preparing a comprehensive and informative plan under this section, the Postal Service may aggregate, disaggregate, or consolidate program activities, except that any aggregation or consolidation may not omit or minimize the significance of any program activity constituting a major function or operation.
- d. The Postal Service may prepare a non-public annex to its plan covering program activities or parts of program activities relating to—
- (1) the avoidance of interference with criminal prosecution; or
  - (2) matters otherwise exempt from public disclosure under section 410(c) of this title.

#### **Sec. 2804. Program performance reports**

- a. The Postal Service shall prepare a report on program performance for each fiscal year, which shall be included in the annual comprehensive statement presented under section 2401(g) of this title.
- b.
1. The program performance report shall set forth the performance indicators established in the Postal Service performance plan, along with the actual program performance achieved compared with the performance goals expressed in the plan for that fiscal year.
  2. If performance goals are specified by descriptive statements of a minimally effective program activity and a successful program activity, the results of such program shall be described in relationship to those categories, including whether the performance failed to meet the criteria of either category.

- 
- c. The report for fiscal year 2000 shall include actual results for the preceding fiscal year, the report for fiscal year 2001 shall include actual results for the two preceding fiscal years, and the report for fiscal year 2002 and all subsequent reports shall include actual results for the three preceding fiscal years.
  - d. Each report shall—
    - 1. review the success of achieving the performance goals of the fiscal year;
    - 2. evaluate the performance plan for the current fiscal year relative to the performance achieved towards the performance goals in the fiscal year covered by the report;
    - 3. explain and describe, where a performance goal has not been met (including when a program activity's performance is determined not to have met the criteria of a successful program activity under section 2803(b)(2))—
      - (A) why the goal was not met;
      - (B) those plans and schedules for achieving the established performance goal; and
      - (C) if the performance goal is impractical or infeasible, why that is the case and what action is recommended; and
    - 4. include the summary findings of those program evaluations completed during the fiscal year covered by the report.

#### **Sec. 2805. Inherently Governmental functions**

The functions and activities of this chapter shall be considered to be inherently Governmental functions. The drafting of strategic plans, performance plans, and program performance reports under this section shall be performed only by employees of the Postal Service.

### **SEC. 8. CONGRESSIONAL OVERSIGHT AND LEGISLATION.**

- 1. IN GENERAL- Nothing in this Act shall be construed as limiting the ability of Congress to establish, amend, suspend, or annul a performance goal. Any such action shall have the effect of superseding that goal in the plan submitted under section 1105(a)(29) of title 31, United States Code.
- 2. GAO REPORT- No later than June 1, 1997, the Comptroller General of the United States shall report to Congress on the implementation of this Act, including the prospects for compliance by Federal agencies beyond those participating as pilot projects under sections 1118 and 9704 of title 31, United States Code.

### **SEC. 9. TRAINING.**

The Office of Personnel Management shall, in consultation with the Director of the Office of Management and Budget and the Comptroller General of the United States, develop a strategic planning and performance measurement training component for its management training program and otherwise provide managers with an orientation on the development and use of strategic planning and program performance measurement.

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## **SEC. 10. APPLICATION OF ACT.**

No provision or amendment made by this Act may be construed as—

1. creating any right, privilege, benefit, or entitlement for any person who is not an officer or employee of the United States acting in such capacity, and no person who is not an officer or employee of the United States acting in such capacity shall have standing to file any civil action in a court of the United States to enforce any provision or amendment made by this Act; or
2. superseding any statutory requirement, including any requirement under section 553 of title 5, United States Code.

## **SEC. 11. TECHNICAL AND CONFORMING AMENDMENTS.**

- a. AMENDMENT TO TITLE 5, UNITED STATES CODE- The table of sections for chapter 3 of title 5, United States Code, is amended by adding after the item relating to section 305 the following: 306. Strategic plans.
- b. AMENDMENTS TO TITLE 31, UNITED STATES CODE-
  1. AMENDMENT TO CHAPTER 11- The table of sections for chapter 11 of title 31, United States Code, is amended by adding after the item relating to section 1114 the following:
    - 1115. Performance plans.
    - 1116. Program performance reports.
    - 1117. Exemptions.
    - 1118. Pilot projects for performance goals.
    - 1119. Pilot projects for performance budgeting.
  2. AMENDMENT TO CHAPTER 97- The table of sections for chapter 97 of title 31, United States Code, is amended by adding after the item relating to section 9702 the following: 9703. Managerial accountability and flexibility. 9704. Pilot projects for managerial accountability and flexibility.
- c. AMENDMENT TO TITLE 39, UNITED STATES CODE- The table of chapters for part III of title 39, United States Code, is amended by adding at the end thereof the following new item: 2801.

Speaker of the House of Representatives.  
Vice President of the United States and  
President of the Senate.

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**APPENDIX C**

**DEPARTMENT OF DEFENSE  
APPROPRIATION ACCOUNTS**

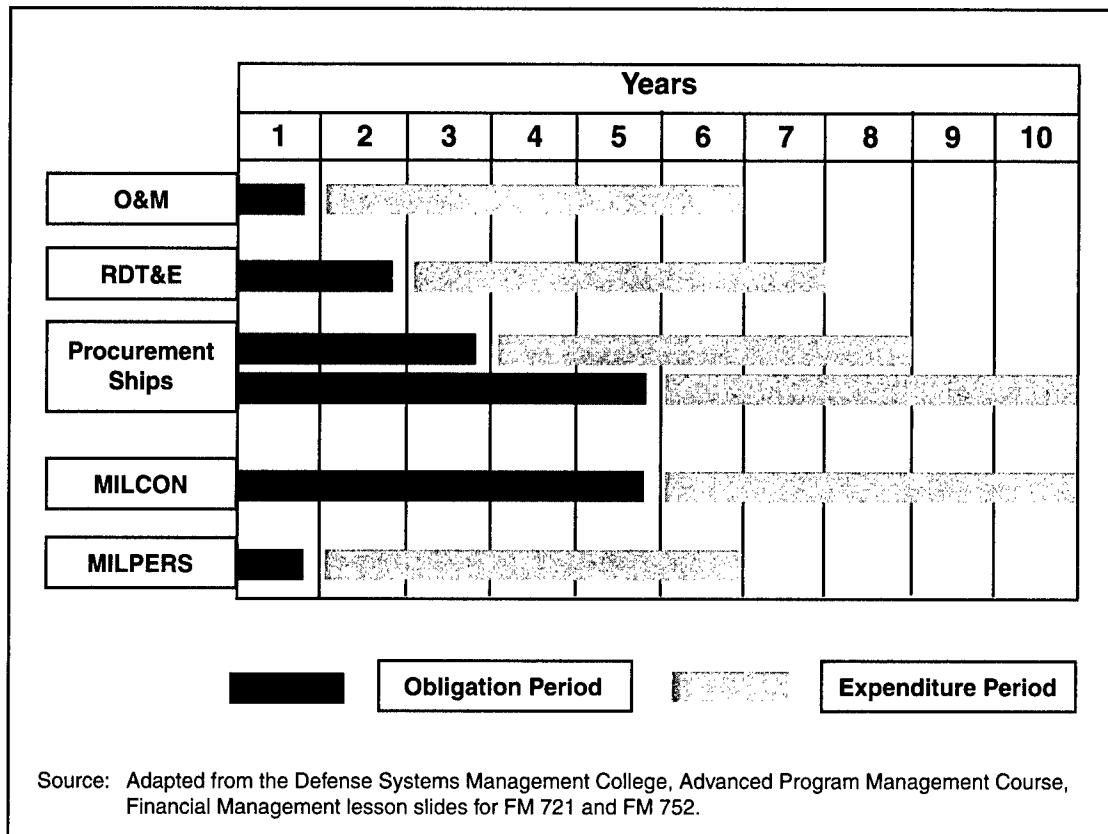
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## APPENDIX C

### DEPARTMENT OF DEFENSE APPROPRIATION ACCOUNTS

Appropriation Accounts	Scope of Work Effort	Service Appropriation Numerical Codes			
		Army	Navy	USMC	Air Force
Research, Development, Test, and Evaluation (RDT&E)	RDT&E Activities, Automated Information Systems Equipment & Software, and Research & Development Facilities	2040	1319		3600
Procurement	Production Labor/Hardware, Initial Spares, Repair Parts, Support Equipment & Facilities, Automated Information Systems Equipment & Software >= \$100K				
	Aircraft	2031	1506		3010
	Missiles	2032			3020
	Weapons		1507		
	Weapons & Tracked Combat Vehicles (W & TCV)	2033			
	Shipbuilding and Conversion (SCN)		1611		
	Ammunition	2034	1508	1508	3011
	Procurement, Marine Corps			1109	
	Other Procurement	2035	1810		3080
Operation & Maintenance (O&M)	Replenishment Spares, Civilian Salaries, Minor Construction < \$500K, Travel, Automated Information Systems Equipment & Software < \$100K, Software Development/ Modifications/ Purchase/ Lease	2020	1804	1106	3400
Military Personnel (MILPERS)	Military Pay & Allowances, Permanent Change of Station Moves, Retired Pay Accrual	2010	1453	1105	3500
Military Construction (MILCON)	Major Construction Projects >\$500K	2050	1205		3300

**Table C-1. Appropriation Accounts by Service**



**Figure C-1. Appropriation Account Life**

The RDT&E and Procurement Appropriation Accounts are collectively referred to as “Modernization.” These two accounts have more flexibility in terms of obligation than one-year O&M money (see Figure C-1). Therefore modernization money is commonly used to pay O&M bills during the annual budget formulations and unexpected or contingency O&M bills during execution.

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**APPENDIX D**  
**OUTSOURCING SURVEY**



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## APPENDIX D

### OUTSOURCING SURVEY

#### Study Methodology and Selected Survey Data

The purpose of the study was to provide an analytical framework for examining the Department of Defense (DoD) from a corporate perspective. With that corporate framework we would develop an approach to outsourcing consistent with a corporate strategy that benefits DoD across the spectrum of DoD-wide, regional, and base-level activities. We tested the hypothesis by answering the following questions through literature searches, interviews with leading DoD and industry experts and outsourcing participants, and a survey:

- Does a transformation urgency exist?
- Do DoD outsourcing initiatives align with DoD Business Strategy?
- Has the OMB Circular A-76 Process generated the results expected?
- Has Strategic or Competitive Sourcing generated the results expected?
- Have shortfalls resulted from execution problems or are they strategy-related?
- What are the benefits of a new corporate strategy approach?
- Can such an approach be implemented?

We constructed a survey (a copy is located at the end of this appendix) to provide data critical to addressing questions one and two. The survey instrument was designed based on the *Outsourcing Justification Practices* study conducted by Pretium Partners, Inc. in partnership with the Fisher College of Business at The Ohio State University, and Michael F. Corbett & Associates. The Pretium study focused on determining and understanding the factors involved in justifying outsourcing decisions, including the tangible and intangible benefits of outsourcing. The study surveyed a random sampling of U.S. and Canadian companies with \$1 billion or more in annual revenue. More than 60 companies responded with detailed information. Our outsourcing survey was modeled after this one in order to facilitate a comparison of the results.

The outsourcing survey was built online with the SurveySuite survey generation tool, which is available for free at the following web address: [http://intercom.virginia.edu/cgi-bin/cgiwrap/intercom/SurveySuite/ss\\_index.pl](http://intercom.virginia.edu/cgi-bin/cgiwrap/intercom/SurveySuite/ss_index.pl). The survey was sent to over 1,300 members of the Department of the Air Force (USAF), Department of the Army (USA), Defense Logistics Agency (DLA), and Department of the Navy (USN). We received over 230 responses, which is about an 18 percent response rate.

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For the USAF and USA, the survey was sent to personnel who are or may be involved in outsourcing initiatives. In the USAF, the survey was sent to the A-76 Commercial Activity program managers and to USAF base and group commanders. Likewise, all garrison and deputy garrison commanders in the USA were specifically targeted.

On the other hand, a completely random sampling was taken from the DLA and USN, using the DLA E-mail directory and Navy/Marine Corps (USMC) White Pages respectively. Although selected at random, command billets were specifically targeted in the USN and USMC. By targeting command and supervisory positions, we were aiming at determining whether the sense of urgency had reached mid-level managers sufficiently to effect change and whether the linkages between DoD corporate strategy and lower-level strategies exist.

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## **OUTSOURCING SURVEY**

### **2001 DAU RESEARCH FELLOWS**

The 2000-2001 DAU Research Fellows are conducting research on the Effectiveness of DoD's Implementation of Outsourcing and Privatization. Our research project focuses on providing a corporate approach to outsourcing that will benefit the entire DoD. The term outsourcing includes A-76, competitive sourcing, strategic sourcing, and privatization. In order to facilitate our research, we ask for 10-15 minutes of your time to complete the following online survey. The information gathered will be presented in a final report scheduled for release in September 2001. For those of you wishing to establish a dialogue with the Research Fellows or request a copy of the report, a space for your contact information has been provided at the end of the survey instrument. We thank you for your input and for devoting time from your busy schedule.

To view the current summary of the DoD Strategic Plan visit the Annual Defense Report web site at <http://www.dtic.mil/execsec/adr2000/appi.html>.

For more information on the DAU Research Fellows program visit <http://www.dsmc.dsm.mil/pubs/mfrpts/mrflist.htm>.

#### **Contact Information:**

Lt Col Warren Anderson, USAF (703) 805-3776  
LTC John McGuiness, USA (703) 805-4655  
CDR John Spicer, USN (703) 805-5410

#### **1. Privacy Act Statement**

The privacy policy is clear: No personal information is collected about you when you visit the web site. Here is how we handle information that is collected and stored automatically about your visit to the web site. While accessing the survey we will gather and store certain information about your visit automatically. This information does not identify you personally. We automatically collect and store only the following information about your visit: the Internet domain (for example, "youragency.gov" if you connect from a government domain, "yourorganization.mil" if you connect from a military domain, or "xcompany.com" if you use a private Internet access account and IP address (an IP address is a number that is automatically assigned to your computer whenever you are surfing the Web) from which you access our web site; the type of browser and operating system used to access our site; the date and time you access our site; the pages you visit; and if you linked to the web site from another web site, the address of that web site. We use this information only for statistical reports to determine the number of visitors to our site and the types of technology used. We do not track or record information about individuals and their visits. We do not enable "cookies" (A cookie is a file placed on

your hard drive by a web site that allows it to monitor your use of the site). Links to Other Sites: This web site has no links to any other web sites. If you have comments or questions about the Privacy Policy, please contact Lt Col Warren Anderson, (703) 805-3776; LTC John McGuiness, (703) 805-4655; or, CDR John Spicer, (703) 805-5410, Monday through Friday.

2. DoD Strategic Plan

The following questions concern the DoD Strategic Plan as outlined in the FY 2000 Annual Defense Report, Appendix I, Government Performance and Results Act. Please mark only one response per question for questions 2.1 - 2.3.

2.1. I have read the DoD Strategic Plan.

Yes

No

2.2. Need exists for significant improvement in the way DoD and the departments/agencies conduct business operations (commercial-like activities).

Yes

No. Please skip to question 3.1

2.3. Business areas the DoD should change or reform. Should the DoD make immediate changes in the following areas?

Yes

No

Not Sure

- a. Acquisition process
- b. Financial management
- c. Information management
- d. Outsourcing initiatives
- e. Other. Please specify in question 2.4

2.4. Other area the DoD should change:

3. DoD Outsourcing Efforts

These questions concern DoD's overall efforts in outsourcing. Please mark only one response per question for questions 3.1, 3.3, and 3.4.

3.1. DoD is headed in the right direction with respect to outsourcing issues.

Yes

No

3.2. Please provide any additional comments regarding your response to question 3.1 above.

3.3. Are the following outsourcing objectives important?

- |  | Not Very<br>Important | Important | Somewhat<br>Important | Very<br>Important | Extremely<br>Important |
|--|-----------------------|-----------|-----------------------|-------------------|------------------------|
|--|-----------------------|-----------|-----------------------|-------------------|------------------------|
- a. For cost control
  - b. For cost savings
  - c. Resources are not available internally
  - d. To better manage the department, unit, or function
  - e. To improve business focus on the primary mission
  - f. To access better capabilities
  - g. To bring new solutions to customers, faster, better, and cheaper
  - h. To improve organizational effectiveness (performing the right function)
  - i. To improve organizational efficiency (performing the function cheaper)
  - j. To respond to shortening product life cycles
  - k. To redefine relationships with suppliers and business partners

3.4. Outsourcing Considerations. The following issues are important considerations when conducting an outsourcing study.

- |                                     | <b>Strongly<br/>Agree</b> | <b>Agree</b> | <b>Neither Agree<br/>nor Disagree</b> | <b>Disagree</b> | <b>Strongly<br/>Disagree</b> |
|-------------------------------------|---------------------------|--------------|---------------------------------------|-----------------|------------------------------|
| a. Impact on Cost                   |                           |              |                                       |                 |                              |
| b. Impact on<br>Personnel           |                           |              |                                       |                 |                              |
| c. Impact on Mission<br>Performance |                           |              |                                       |                 |                              |

4. Your Organization

This section queries sourcing efforts at your organizational or base level. Please mark only one response per question for questions 4.1, 4.3 - 4.7, and 4.9 - 4.11.

4.1. Are there activities within your command/organization that can be better performed by the private sector?

Yes                      No                      Don't know

4.2. If you answered yes to question 4.1 above, please list some examples or otherwise mark N/A.

\_\_\_ Not Applicable

4.3. Have you been involved in an outsourcing effort?

Yes                      No. Please skip to question 5.1

4.4. Outsourcing Processes. Please mark your agreement with the statement, "The \_\_\_\_\_ process is a good process."

- |                                      | <b>Strongly<br/>Agree</b> | <b>Agree</b> | <b>Neither Agree<br/>nor Disagree</b> | <b>Disagree</b> | <b>Strongly<br/>Disagree</b> |
|--------------------------------------|---------------------------|--------------|---------------------------------------|-----------------|------------------------------|
| a. A-76                              |                           |              |                                       |                 |                              |
| b. Navy's Strategic<br>Sourcing      |                           |              |                                       |                 |                              |
| c. Air Force's<br>Strategic Sourcing |                           |              |                                       |                 |                              |
| d. Army's Competitive<br>Sourcing    |                           |              |                                       |                 |                              |

4.5. Did you use metrics to measure the performance of the outsourced activity?

Yes

No

4.6. Were the metrics effective?

Yes

No

Not Applicable

4.7. Did you change the metrics after implementation to provide greater visibility into your process?

Yes

No

Not Applicable

4.8. If you answered yes to question 4.7 above, please briefly explain or otherwise mark N/A.

\_\_\_ Not Applicable (N/A)

4.9. Outsourcing Alignment to Strategy and Planning. Was the outsourcing effort aligned to:

Yes

No

Not Sure

N/A

- a. DoD Corporate Strategy
- b. Your Service's/ Department's/  
Agency's Strategy
- c. Your Major Command's  
Strategy
- d. Your Unit's Strategy
- e. Your Function's/  
Department's Strategy
- f. Human Resource Strategy
- g. Operational Plans

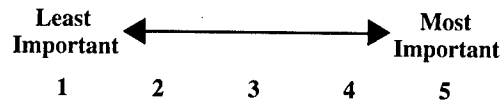
4.10. Outsourcing has improved or enhanced my mission performance.

Yes

No. Please skip to question 5.1



4.11. Outsourcing Benefits. Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with 1 being the least important and 5 being the most important.



- a. Reduced cost
- b. Provided savings
- c. Provided resources that were not available internally
- d. Allowed better management of the department, unit, or function
- e. Improved business focus onto the primary mission
- f. Allowed access to better capabilities
- g. Brought solutions to customers, faster, better, and cheaper
- h. Improved organizational effectiveness (performing the right function)
- i. Improved organizational efficiency (performing the function cheaper)
- j. Enabled shortened product life cycles
- k. Redefined better relationships with suppliers and business partners
- l. Other benefit. Please explain in question 4.12

4.12. Please briefly describe the other benefit derived from your outsourcing effort. If you did not mark other benefit, please respond N/A.

\_\_\_ Not Applicable

5. Demographics

The questions in this section ask about you and your current position. All responses are confidential. Please mark only one response per question.

5.1. What department or branch of service are you in or are you in industry?

- ☐ Office of Secretary of Defense
- ☐ United States Marine Corps
- ☐ United States Army
- ☐ United States Navy
- ☐ United States Air Force
- ☐ Other DoD Agency
- ☐ Other Government Agency
- ☐ Industry Representative

5.2. What is your rank / grade? If Industry please mark N/A.

- ☐ O-1 to O-2 / GS-09 to GS-11
- ☐ O-3 to O-4 / GS-12 to GS-13
- ☐ O-5 to O-6 / GS-14 to GS-15
- ☐ General Officer / Flag Officer / Senior Executive
- ☐ Other
- ☐ Not Applicable

5.3. How many years of government service do you have? If Industry please mark N/A.

- ☐ 0 – 5 years
- ☐ 6 – 10 years
- ☐ 11 – 15 years
- ☐ 16 – 20 years
- ☐ 21 – 25 years
- ☐ 26 years or longer
- ☐ Not Applicable

5.4. Are you in a supervisory or command position? Please mark all that apply.

- ☐ Command
- ☐ Supervisor
- ☐ Not in a command/supervisory position

5.5. What is your current function or area of expertise?

- ☐ Program Management
- ☐ Research and Development
- ☐ Engineering
- ☐ Supply/Logistics
- ☐ Budget/Finance
- ☐ Contracting
- ☐ Other

5.6. What best describes the role of your unit.

- ☐ Policy/Staff
- ☐ Support/Business enterprise
- ☐ Operational
- ☐ Other

5.7. Please rate your own expertise in outsourcing.

- ☐ Very Little (Less than a year)
- ☐ Some (1 – 2 years)
- ☐ Average (2 – 4 years)
- ☐ Above Average (4 – 5 years)
- ☐ Significant (More than 5 years)

6. Contact Information Please provide contact information if you desire.

6.1. Name

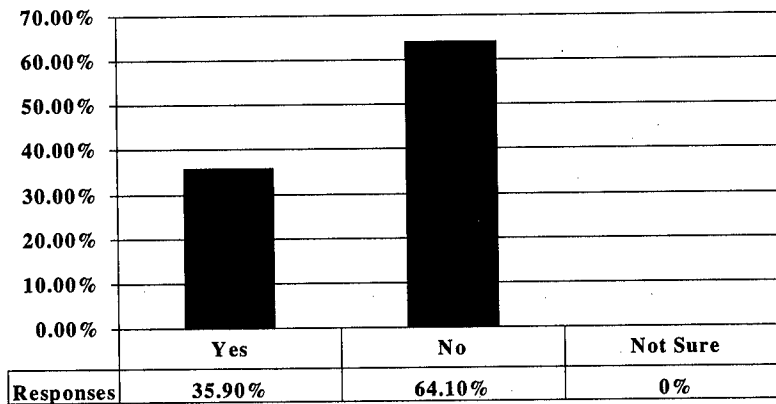
6.2. Phone Number (DSN and Commercial)

6.3. If you would like a copy of the final report, please provide your mailing address.

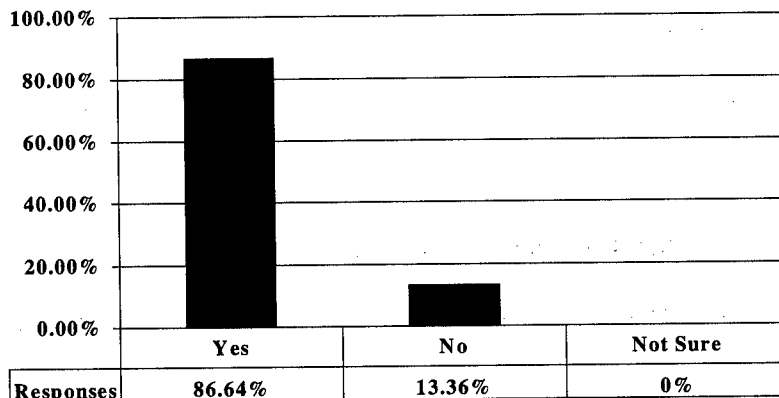
## SURVEY RESPONSES

The following figures summarize the survey responses.

### I have read the DoD Strategic Plan

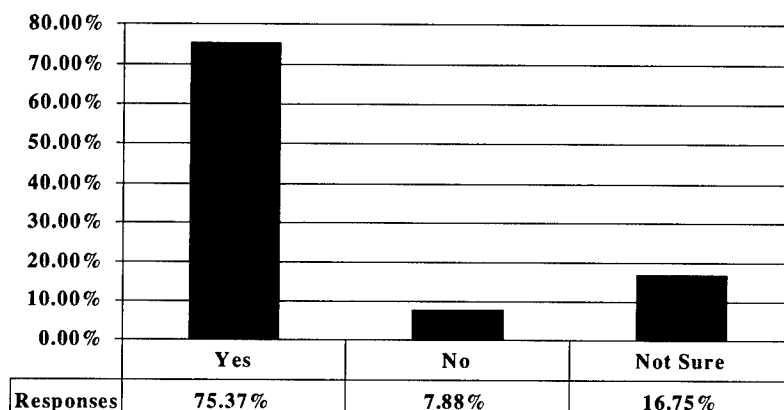


### Need exists for significant improvement in the way DoD and the departments/agencies conduct business operations (commercial like activities)



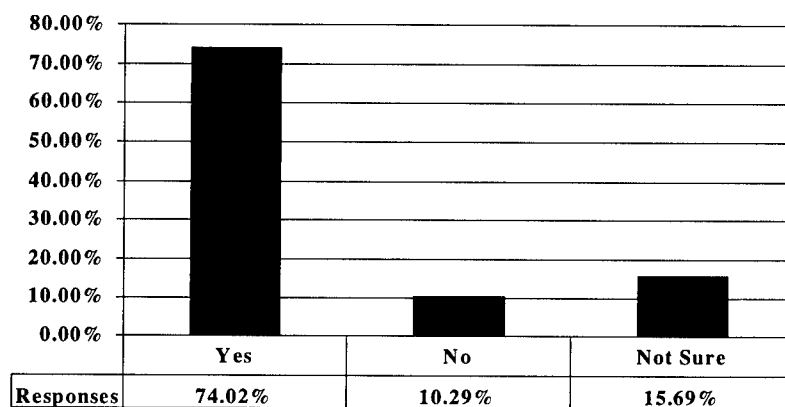
Business areas that DoD should change or reform.  
Should DoD make immediate changes in the following  
areas?

Acquisition Process



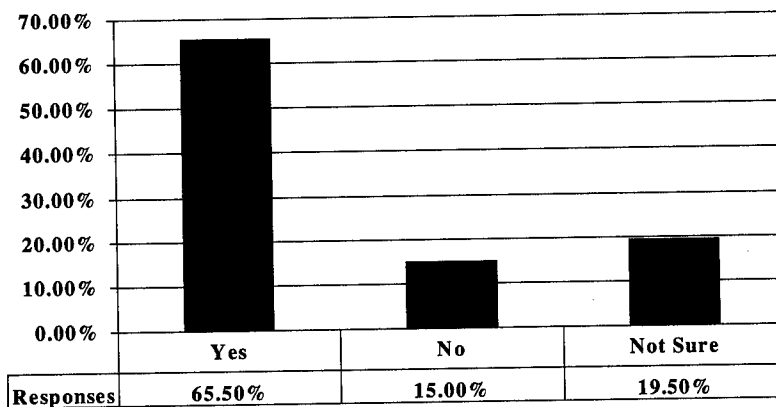
Business areas that DoD should change or reform.  
Should DoD make immediate changes in the following  
areas?

Financial Management



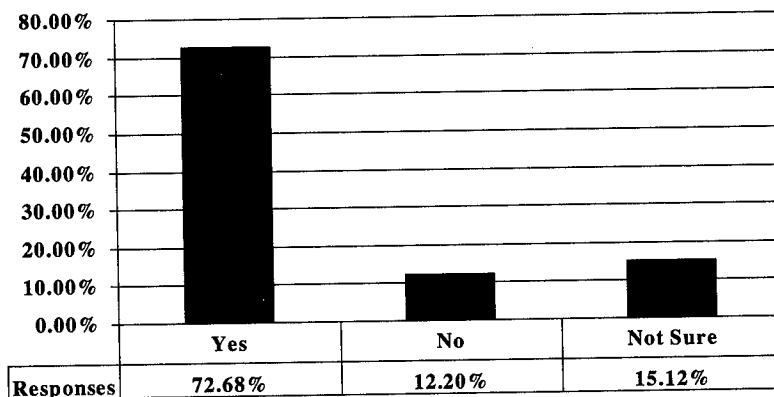
Business areas that DoD should change or reform.  
Should DoD make immediate changes in the following  
areas?

Information Management

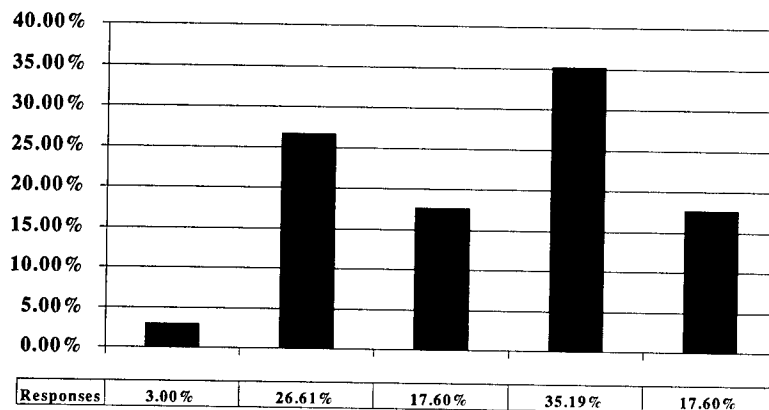


Business areas that DoD should change or reform.  
Should DoD make immediate changes in the following  
areas?

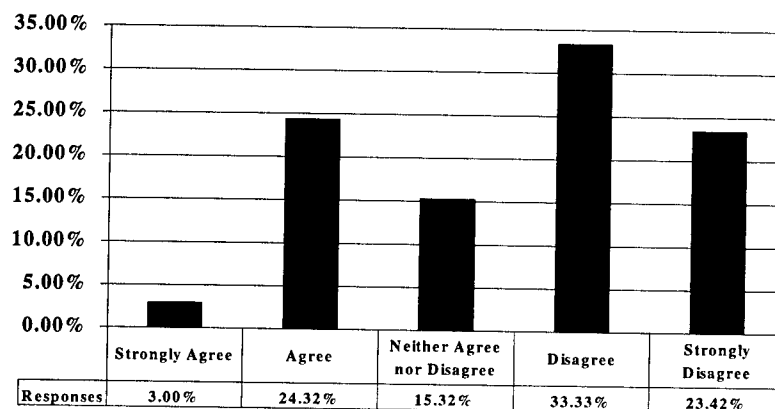
Outsourcing Initiatives



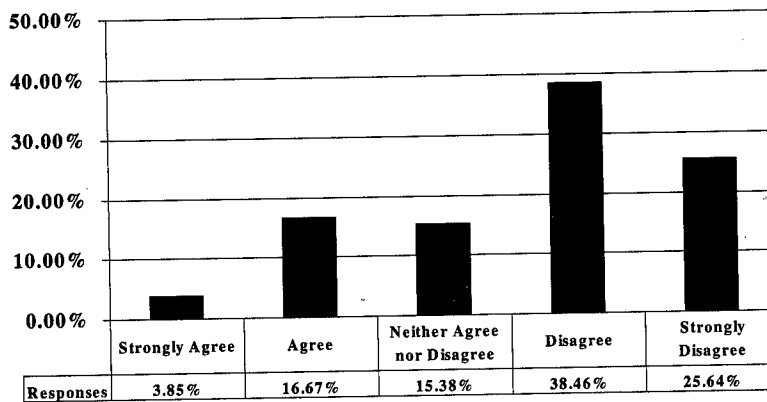
DoD is headed in the right direction with respect to outsourcing.



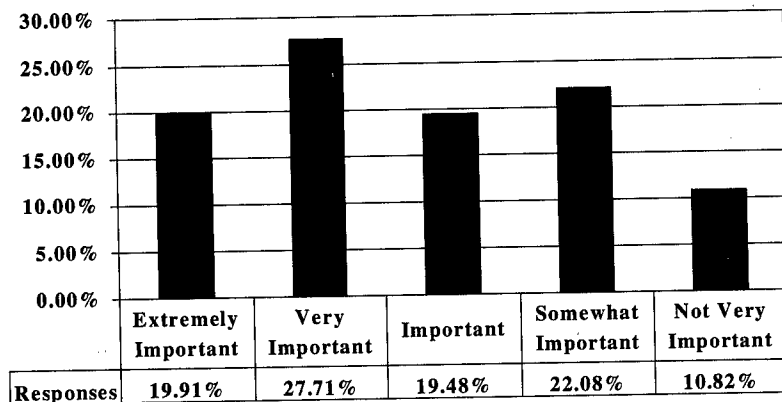
*Commanders* responding to the statement: DoD is headed in the right direction with respect to outsourcing.



**Commanders** who have undergone outsourcing responding to the statement: DoD is headed in the right direction with respect to outsourcing.

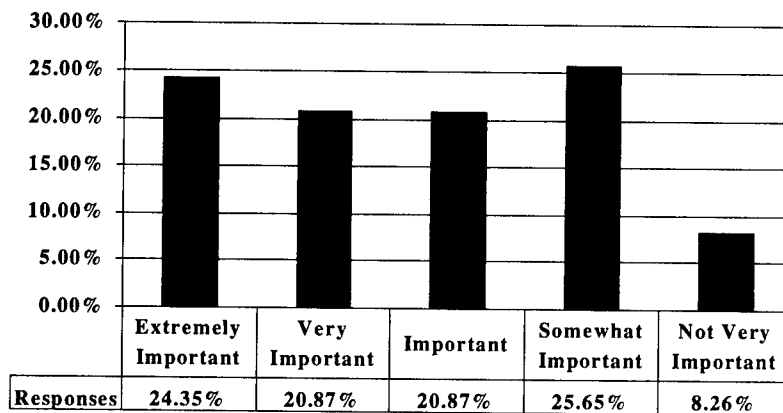


Are the following outsourcing objectives important?  
For cost control

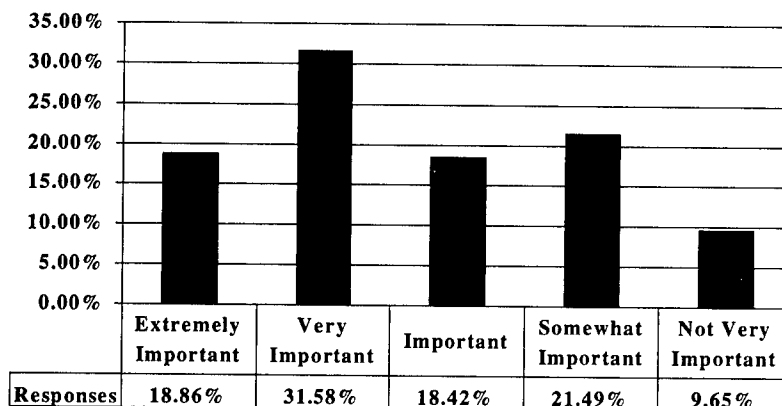




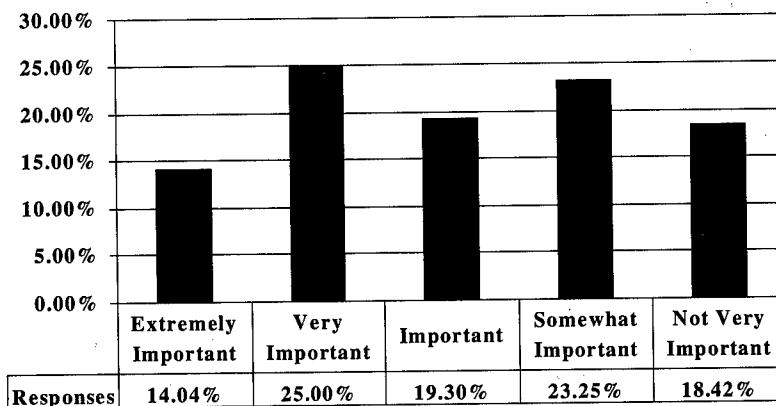
Are the following outsourcing objectives important?  
For cost savings



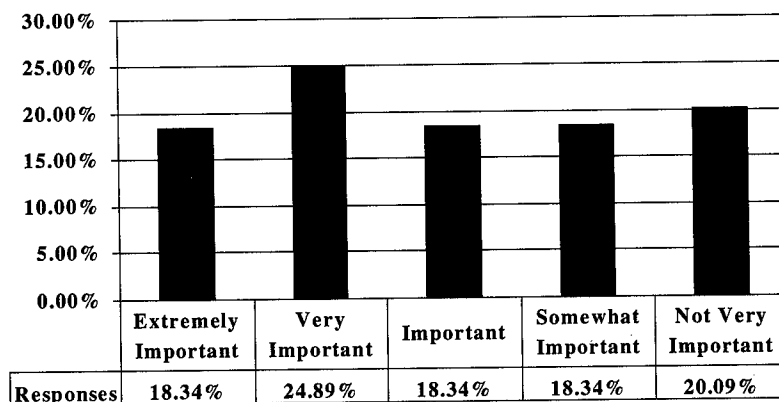
Are the following outsourcing objectives important?  
Resources are not available internally



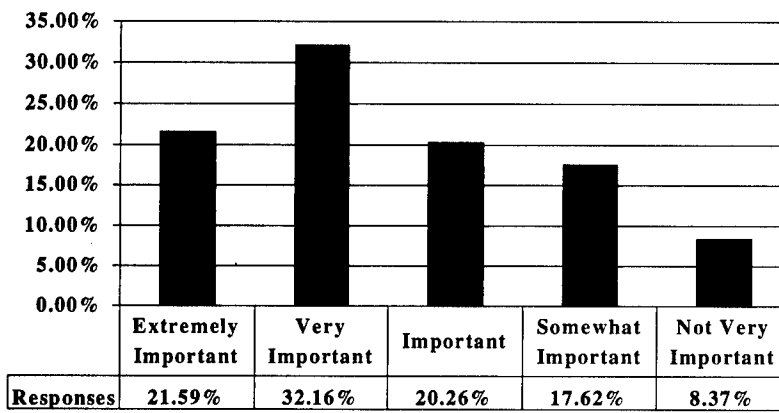
Are the following outsourcing objectives important?  
To better manage the department, unit or function



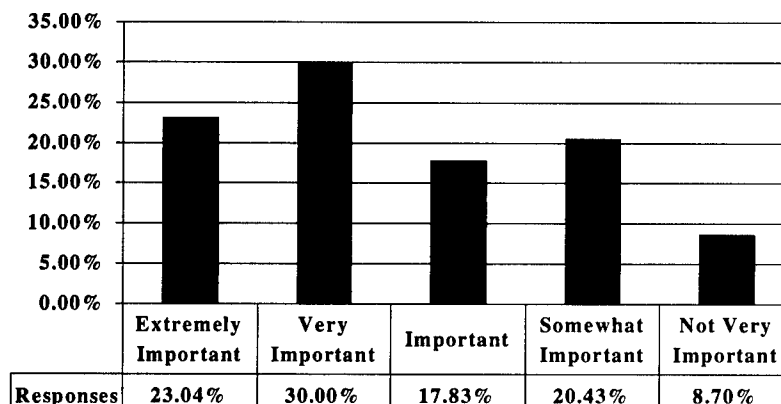
Are the following outsourcing objectives important?  
To improve business focus on the primary mission



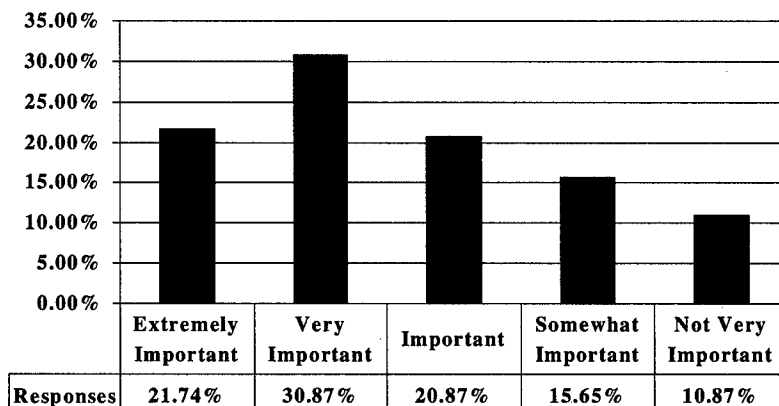
Are the following outsourcing objectives important?  
To access better capabilities



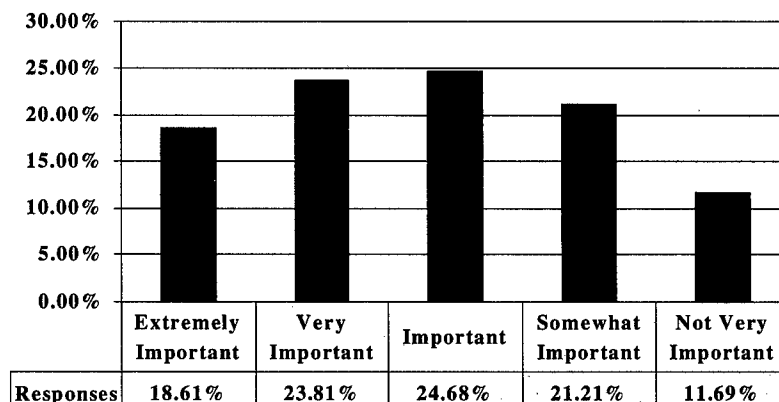
Are the following outsourcing objectives important?  
To bring new solutions to customers faster, better, and cheaper



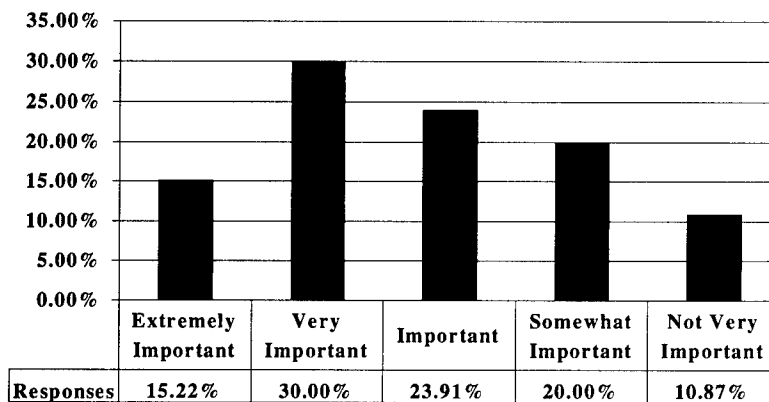
Are the following outsourcing objectives important?  
To improve organizational effectiveness (performing the  
right function)



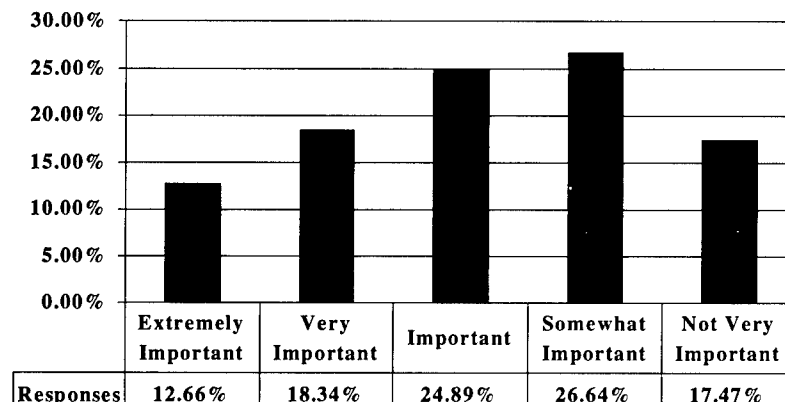
Are the following outsourcing objectives important?  
To improve organizational efficiency (performing the  
function cheaper)



Are the following outsourcing objectives important?  
To respond to shortening product life-cycles

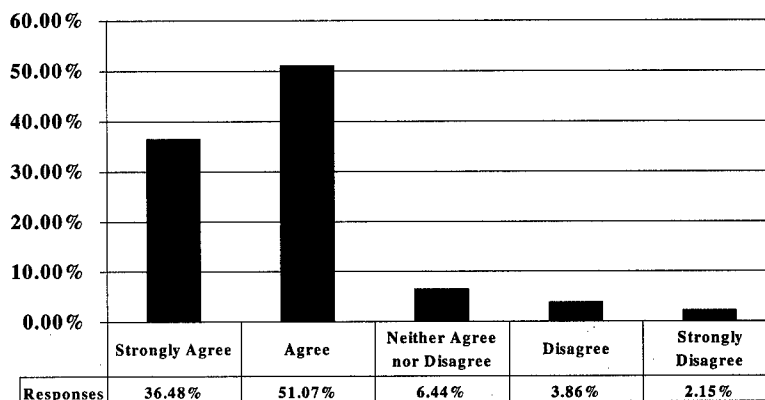


Are the following outsourcing objectives important?  
To redefine relationships with suppliers and business partners



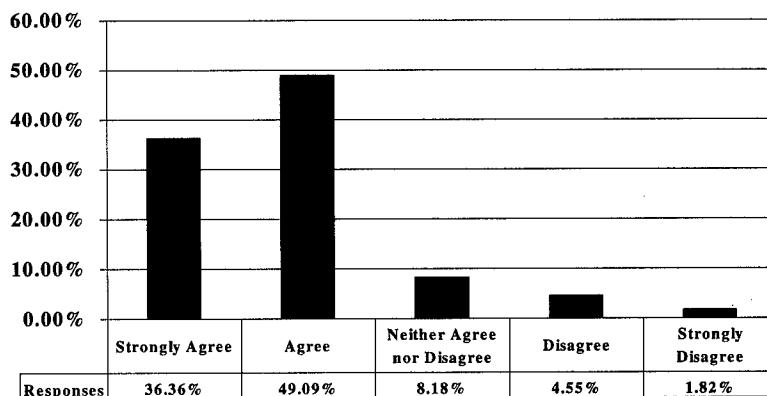
The following issues are important considerations when conducting an outsourcing study.

Impact on cost



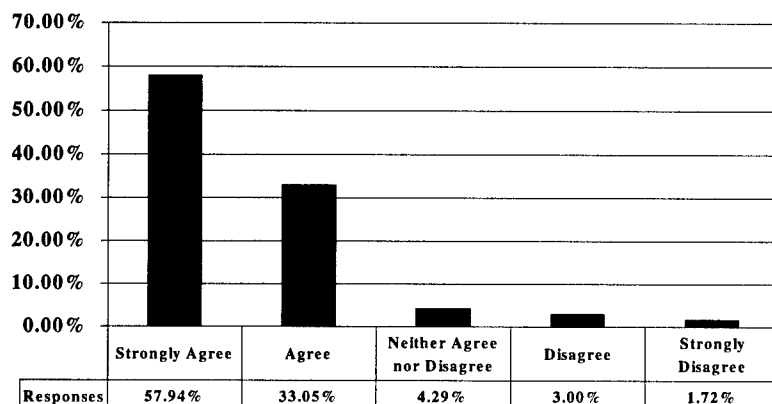
*For commanders:* The following issues are important considerations when conducting an outsourcing study.

Impact on cost



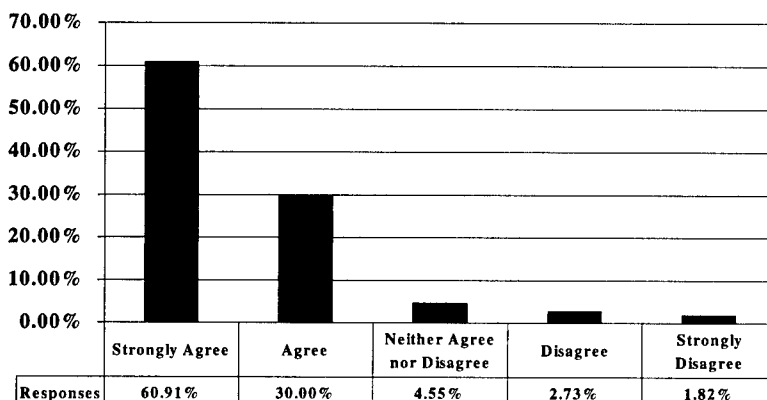
The following issues are important considerations when conducting an outsourcing study.

Impact on personnel

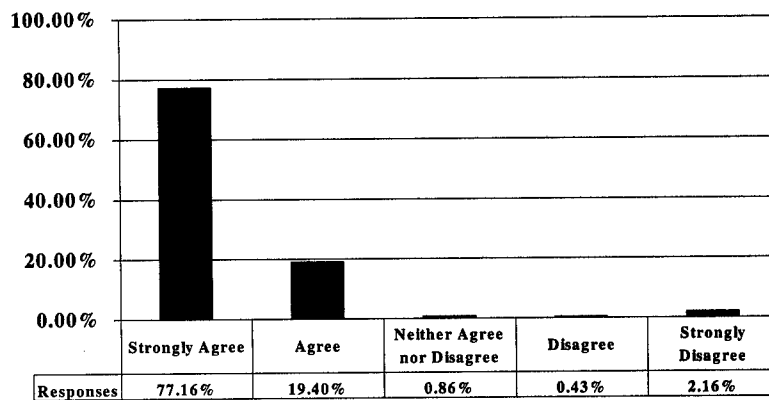


*For commanders:* The following issues are important considerations when conducting an outsourcing study.

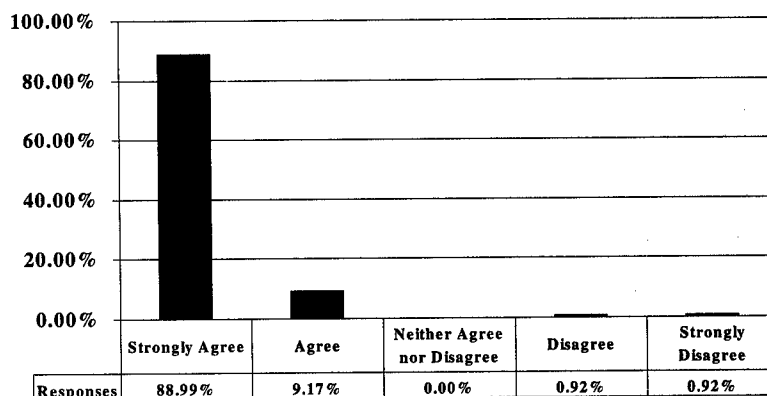
Impact on personnel



The following issues are important considerations when conducting an outsourcing study.  
Impact on mission performance

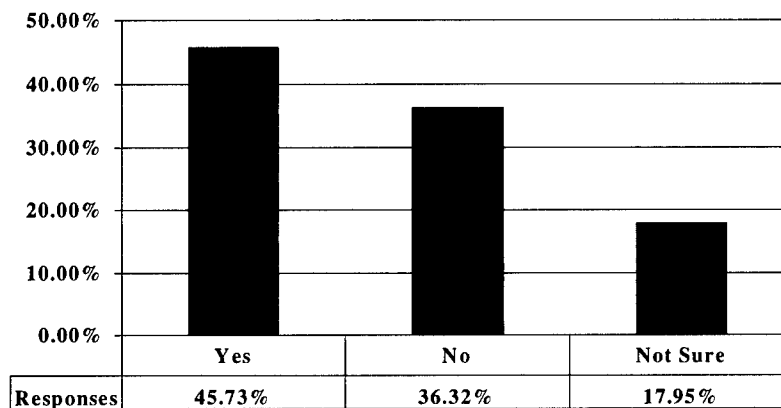


*For commanders:* The following issues are important considerations when conducting an outsourcing study.  
Impact on mission performance

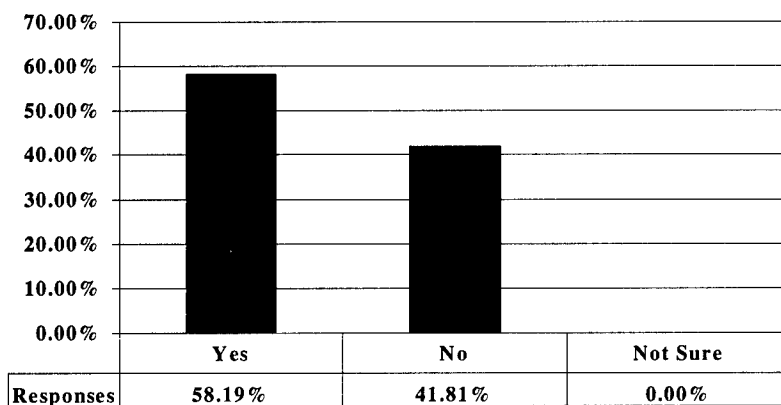




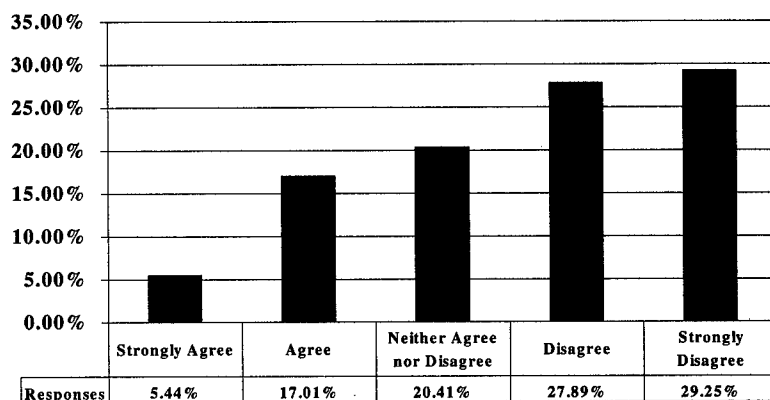
Are there activities within your command/organization that can be better performed by the private sector?



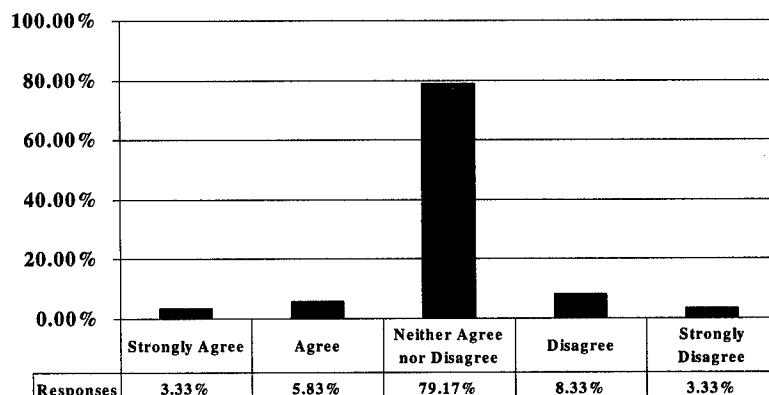
Have you been involved in an outsourcing effort?



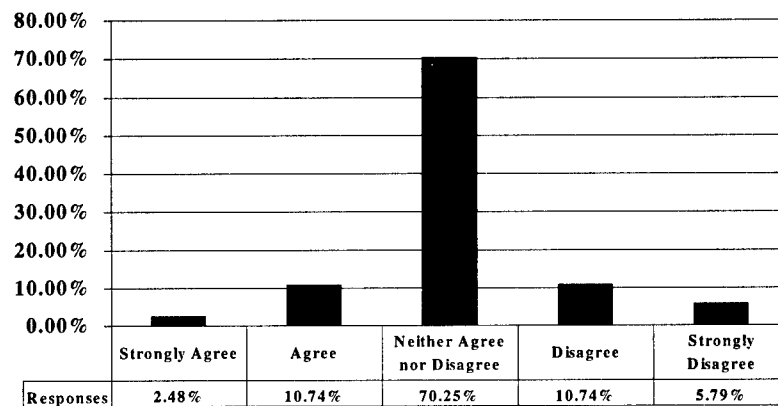
Please mark your agreement with the statement:  
 “The A-76 process is a good process.”



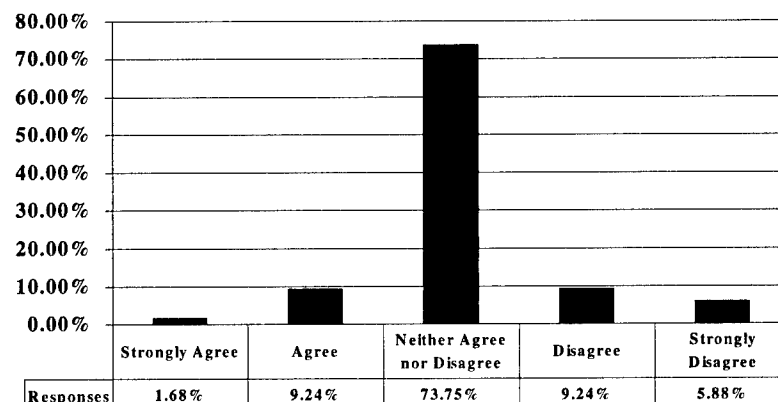
Please mark your agreement with the statement:  
 “The Navy’s Strategic Sourcing process is a good process.”



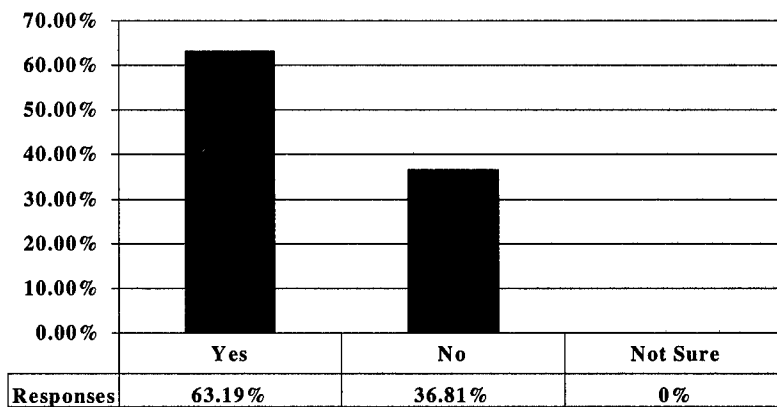
Please mark your agreement with the statement:  
 “The Air Force’s Strategic Sourcing process  
 is a good process.”



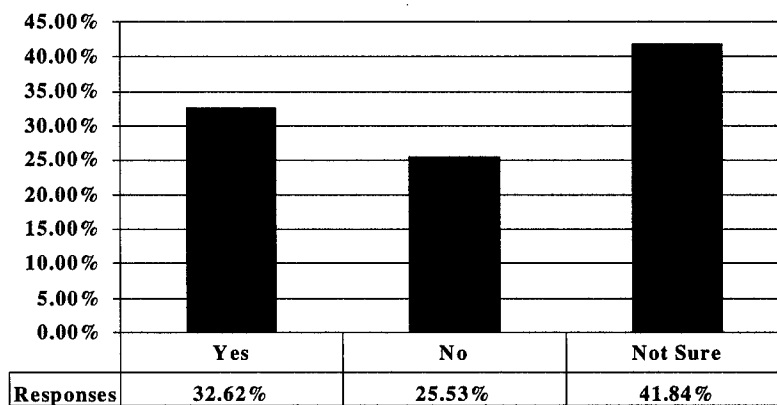
Please mark your agreement with the statement:  
 “The Army’s Competitive Sourcing process  
 is a good process.”



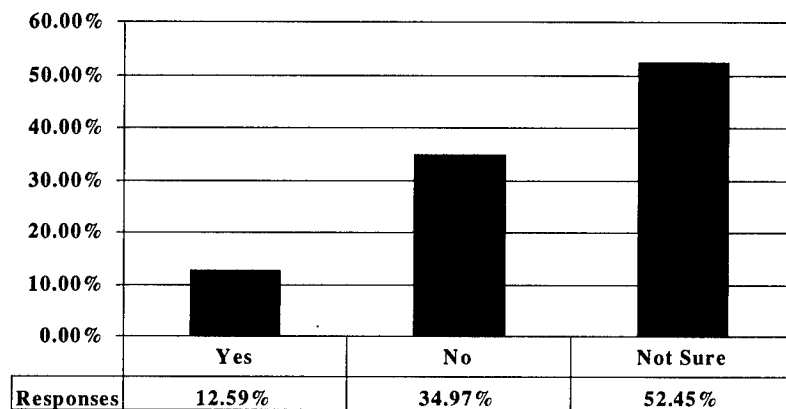
Did you use metrics to measure the performance of the outsourced activity?



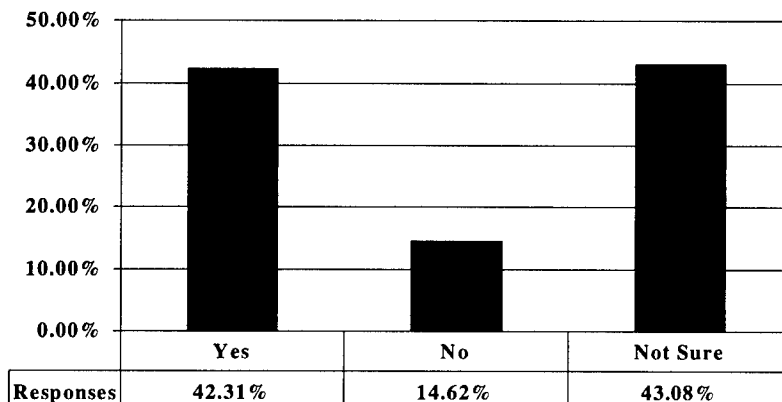
Were the metrics effective?



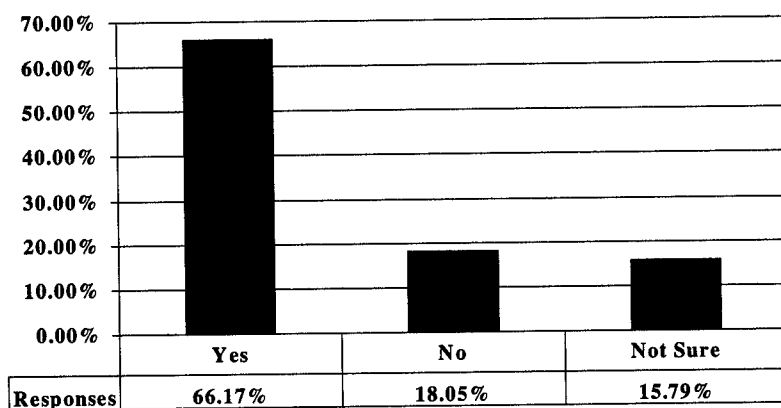
Did you change the metrics after implementation to provide greater visibility into your process?



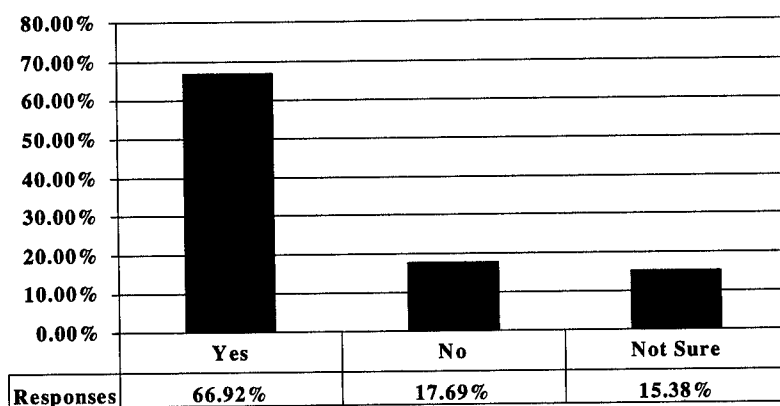
Was the outsourcing effort aligned to:  
DoD corporate strategy?



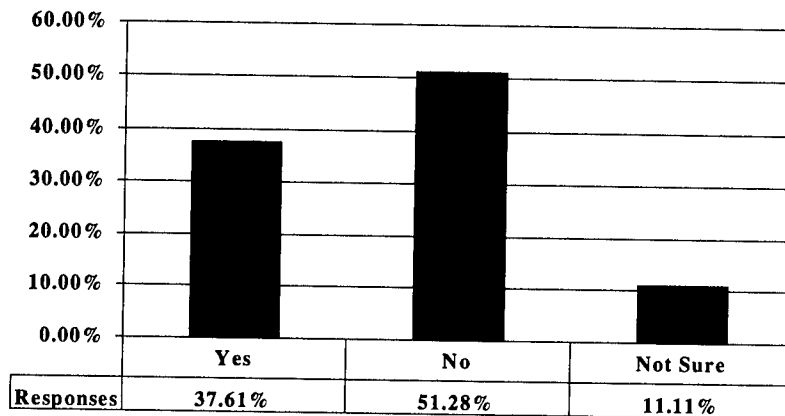
Was the outsourcing effort aligned to:  
Your Service's/agency's strategy?



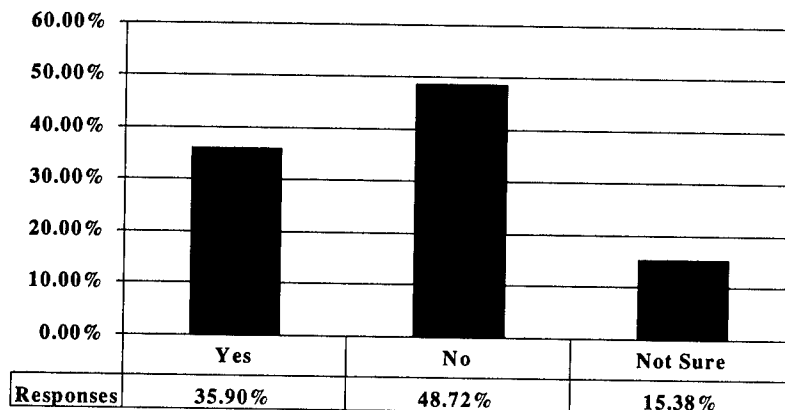
Was the outsourcing effort aligned to:  
Your major command's strategy?



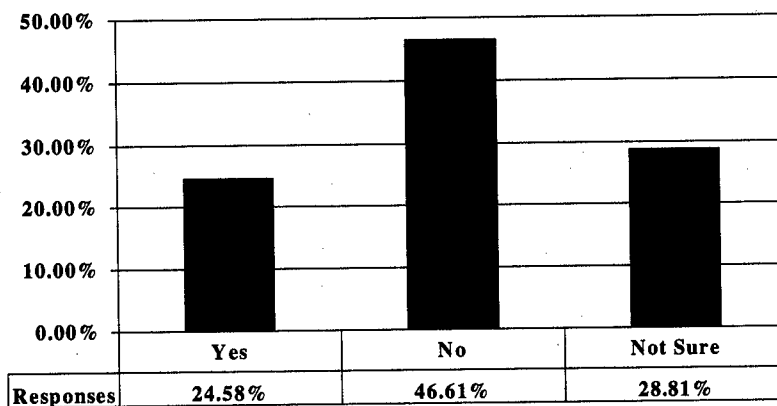
Was the outsourcing effort aligned to:  
Your unit's strategy?



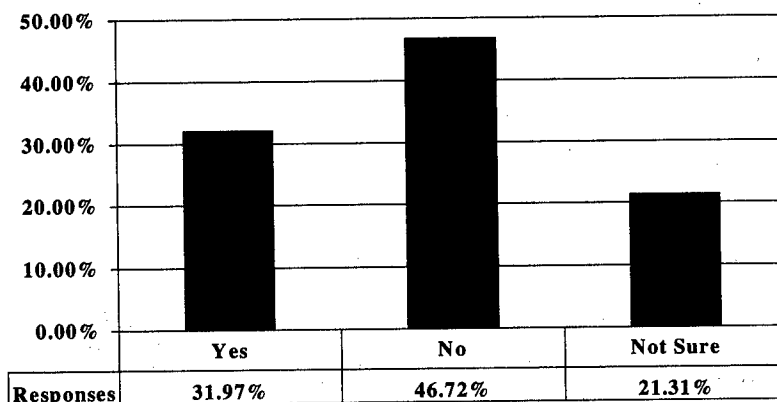
Was the outsourcing effort aligned to:  
Your function's/department's strategy?



Was the outsourcing effort aligned to:  
Human resource strategy?

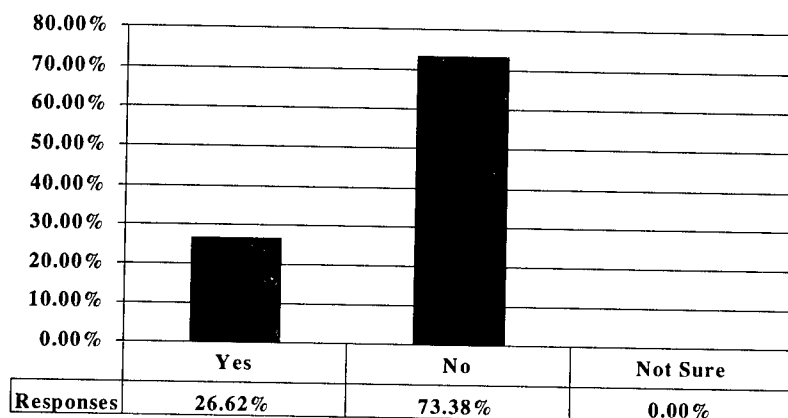


Was the outsourcing effort aligned to:  
Operational plans?



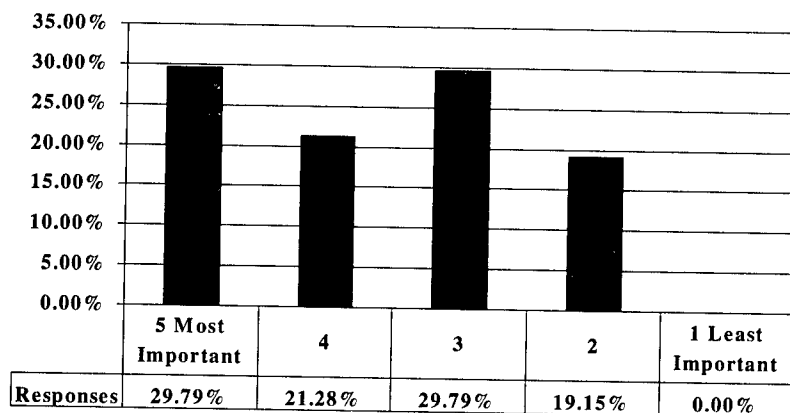


Outsourcing has improved or enhanced my mission performance.



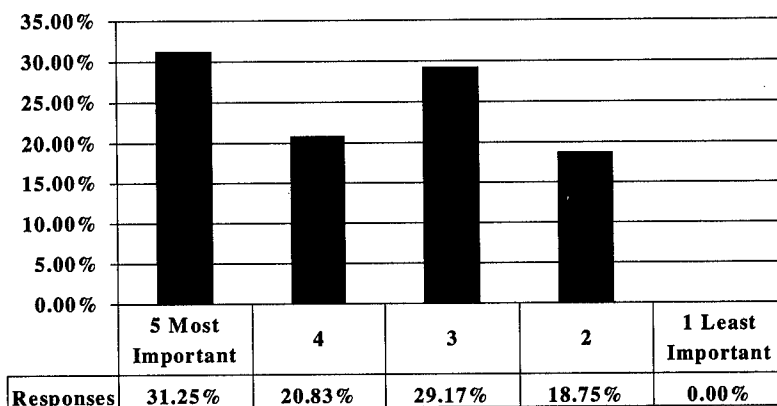
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Reduced Cost



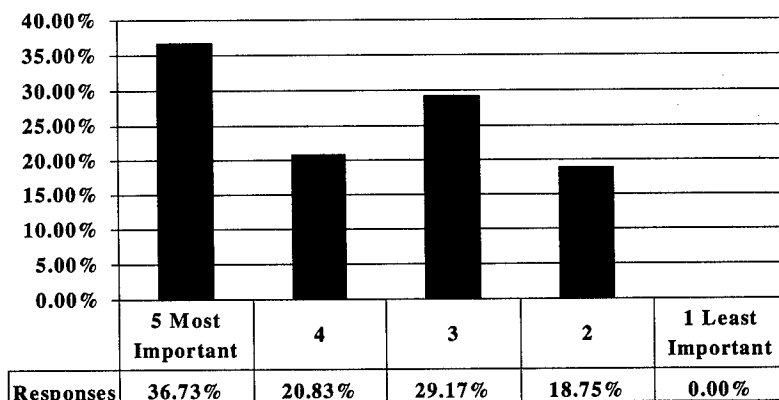
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Provided Savings



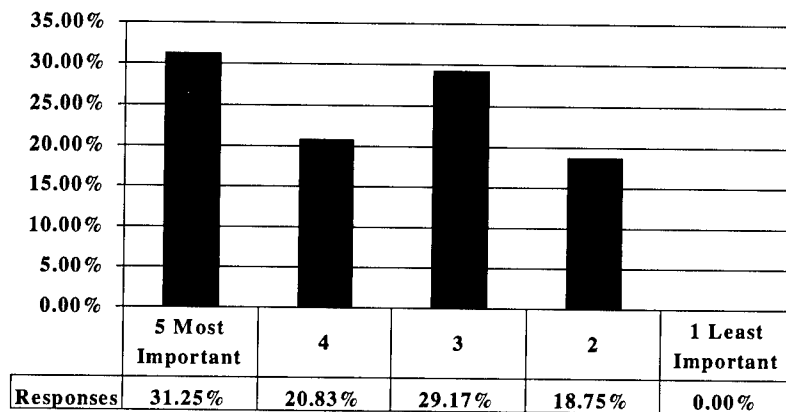
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Provided resources that were not available internally



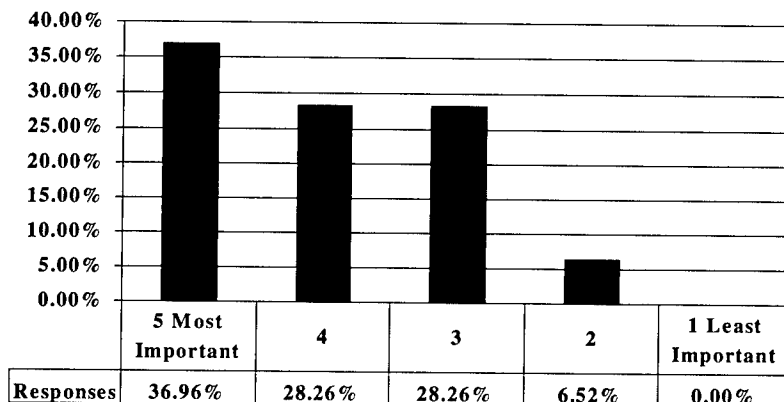
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Allowed better management of the department, unit, or function



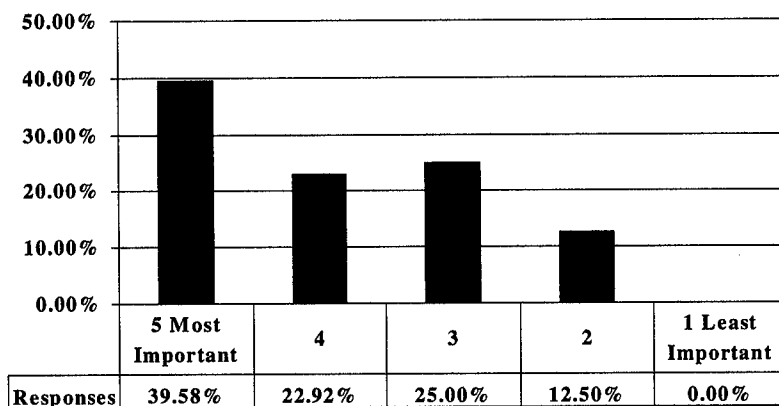
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Improved focus onto the primary mission



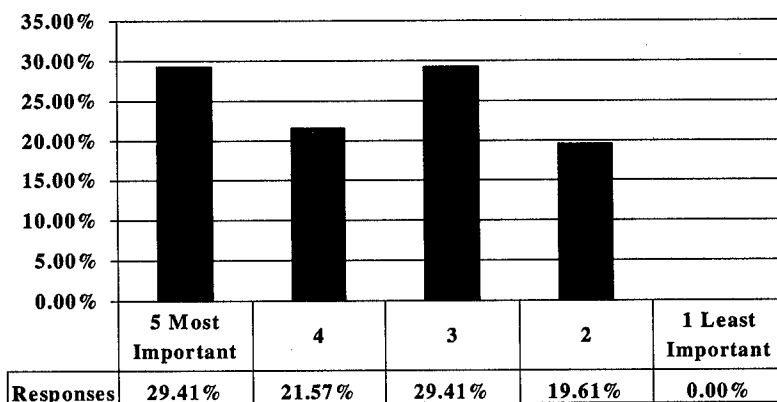
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Allowed access to better capabilities



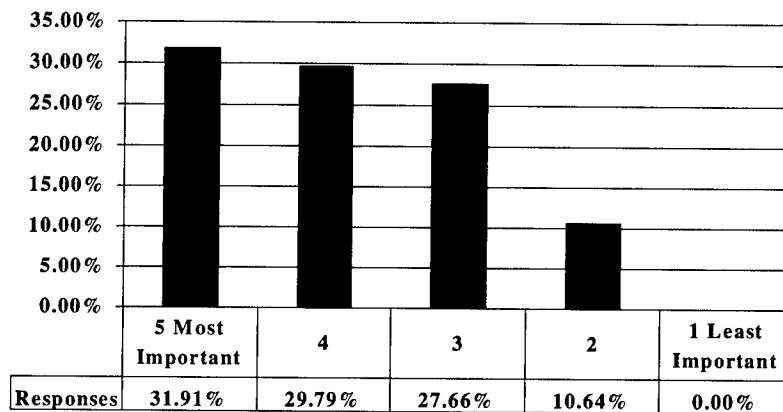
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Brought solutions to customers, faster, better, and cheaper



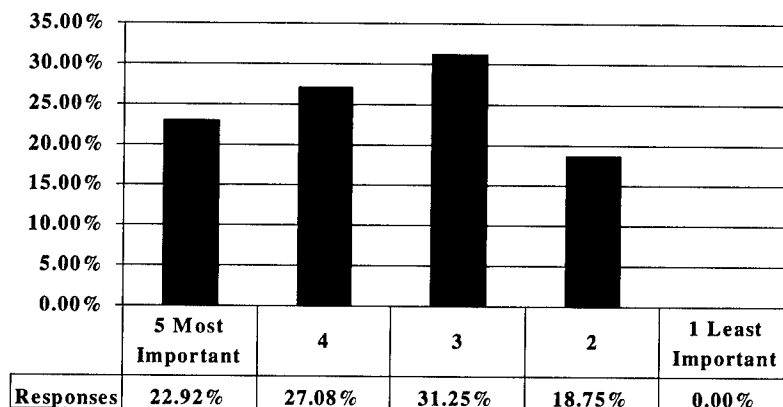
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Improved organizational effectiveness (doing the right function)



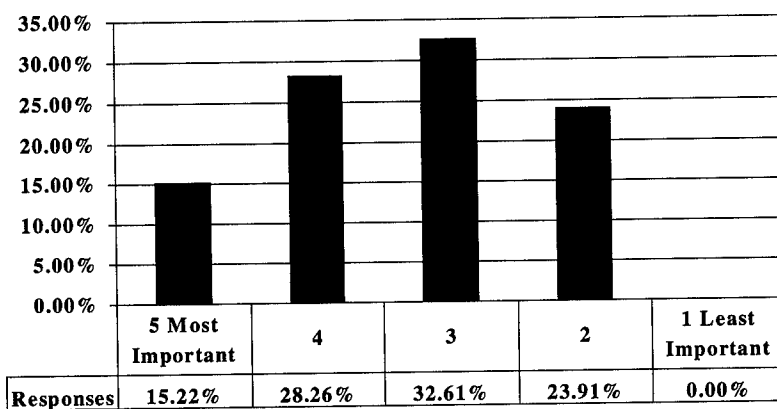
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Improved organizational efficiency (performing the function cheaper)



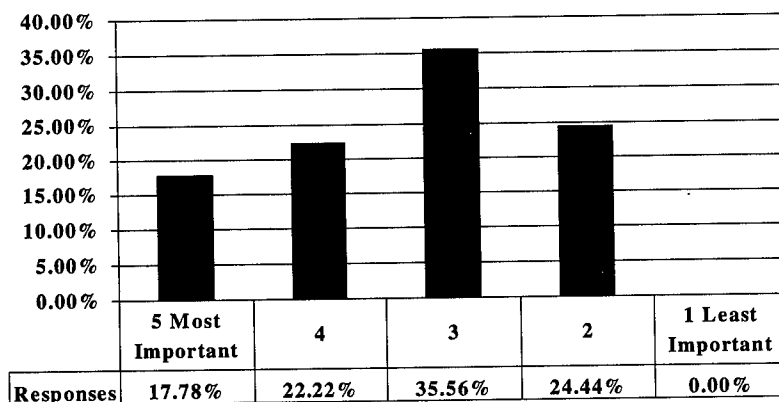
Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Enabled shortened product life-cycles



Please rate the following potential benefits resulting from your outsourcing effort on a 5-point basis, with one being the least important and five being the most important.

Redefined better relationships with suppliers and business partners



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#### ENDNOTES

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1. *Value Assessment in Outsourcing: A Study of Outsourcing Justification Practices*, Pretium Partners, Inc., Columbus, OH.

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**APPENDIX E**  
**CONTACTS**





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## APPENDIX E

### CONTACTS

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**APPENDIX F**  
**SELECTED BIBLIOGRAPHY**

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## APPENDIX F

### SELECTED BIBLIOGRAPHY

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**APPENDIX G**  
**ACRONYMS**



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## **APPENDIX G**

### **ACRONYMS**

**ABC** – Activity Based Costing  
**ADP** – automatic data processing  
**ADR** – Annual Defense Report  
**AF** – Air Force  
**AFGE** – American Federation of Government Employees  
**AOL** – America Online  
**BRAC** – Base Realignment and Closure  
**BUR** – Bottom-Up Review  
**CAMIS** – Commercial Activities Management Information System  
**CD** – Compact Disc  
**CSIS** – Center for Strategic and International Studies  
**DAU** – Defense Acquisition University  
**DEC** – Digital Equipment Corporation  
**DLA** – Defense Logistics Agency  
**DoD** – Department of Defense  
**DRI** – Defense Reform Initiative  
**DRID** – Defense Reform Initiative Directive  
**DSB** – Defense Science Board  
**DSMC** – Defense Systems Management College  
**ERP** – Enterprise Resource Planning  
**EU** – European Union  
**FAIR** – Federal Activities Inventory Reform Act  
**FAR** – Federal Acquisition Regulation  
**FTE** – Full Time Equivalent  
**FY** – fiscal year

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**GAO** – General Accounting Office  
**GE** – General Electric  
**GM** – General Motors  
**GOCO** – Government Owned / Contractor Operated  
**GPRA** – Government Performance and Results Act  
**GS** – General Schedule  
**HBS** – Harvard Business School  
**IBM** – International Business Machines  
**ISSA** – Interservice Support Agreement  
**IT** – Information Technology  
**JIT** – Just-in-Time  
**JWOD** – Javits-Wagner-O'Day  
**LM** – Lockheed Martin  
**MCE** – Manufacturing Cycle Effectiveness  
**MEO** – Most Efficient Organization  
**NAFTA** – North American Free Trade Agreement  
**NATO** – North Atlantic Treaty Organization  
**NG** – Northrop Grumman  
**NIB** – National Industries for the Blind  
**NISH** – National Industries for the Severely Handicapped  
**OFPP** – Office of Federal Procurement Policy  
**OMB** – Office of Management and Budget  
**OPM** – Office of Personnel Management  
**OSD** – Office of the Secretary of Defense  
**PC** – Personal Computer  
**PIP** – Privatization in Place  
**PMD** – Program for Management Development  
**PPBS** – Planning, Programming, and Budgeting System  
**PWS** – Performance Work Statement

**QASP** – Quality Assurance Surveillance Plan

**QDR** – Quadrennial Defense Review

**R&D** – Research and Development

**RBA** – Revolution in Business Affairs

**RCA** – Radio Corporation of America

**RMA** – Revolution in Military Affairs

**ROM** – Return on Management

**SC** – Supply Corps

**TAC** – Tactical Air Command

**TMSI** – Targeted Marketing Solutions, Inc.

**TQM** – Total Quality Management

**U.S.** – United States

**USA** – United States Army

**USAF** – United States Air Force

**USN** – United States Navy

**USPS** – United States Postal Service

**VCR** – Video Cassette Recorder

**WG** – Wage Grade

**WTO** – World Trade Organization

**WWW** – World Wide Web



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**APPENDIX H**  
**ABOUT THE AUTHORS**



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## **APPENDIX H**

### **ABOUT THE AUTHORS**

**Lt Col Warren M. Anderson, USAF**, has had various acquisition-related jobs during his career. These included work in laboratory research and development, test and evaluation, policy formulation, and program analysis. He has worked on spacecraft thermal control systems, hypersonic technology, antisatellite weapons, ballistic missiles, and satellite systems. Most recently he was Chief of the SAF/AQ Staff Group. Lt Col Anderson holds a Bachelor of Science in Chemistry, Bachelor of Aerospace Engineering, and Master of Science in Industrial Management from the Georgia Institute of Technology. He is a graduate of Squadron Officer School, Air Command and Staff College, and the Advanced Program Management Course. He is a Level III Certified Acquisition Professional in Program Management, Test and Evaluation, and Systems Planning, Research, Development, and Engineering. Lt Col Anderson is also a graduate of the Program for Management Development at the Harvard Business School.

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**LTC John J. McGuiness, USA**, has served in various Infantry leadership and command positions. His acquisition assignments include Assistant Product Manager for Mortar Systems and Department of the Army Staff Coordinator for Bradley Systems. His most recent assignment was as the Systems Integration Officer, Office of the Assistant Secretary of the Army for Acquisition, Logistics, and Technology. LTC McGuiness holds a Bachelor of Science degree from the United States Military Academy, West Point, and a Master of Science degree from the Air Force Institute of Technology. He is a graduate of the Infantry Officer Basic Course, the Armor Officer Advanced Course, Combined Arms and Service Staff School, the Army Command and General Staff College, and the Advanced Program Management Course. He is also a graduate of the Program for Management Development at the Harvard Business School.

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